



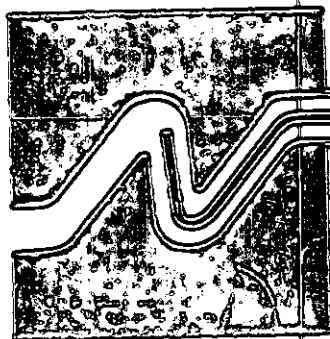
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2006 Annual Report



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Naugatuck Valley Financial Corporation

Naugatuck Valley Financial Corporation, headquartered in Naugatuck, Connecticut, is the holding company for Naugatuck Valley Savings and Loan. A majority of the outstanding shares of Naugatuck Valley Financial's common stock are owned by Naugatuck Valley Mutual Holding Company, the mutual holding company for Naugatuck Valley Savings. Naugatuck Valley Savings operates as a community-oriented financial institution, dedicated to serving the financial service needs of consumers and businesses with a variety of deposit and loan products from its nine full-service banking offices in the Greater Naugatuck Valley Region of southwestern Connecticut.



333 Church Street, Naugatuck CT 06770-2806 (203) 720-5000

Dear Stockholders,

During 2006 Naugatuck Valley Financial Corporation continued to build value for its customers, employees and shareholders by taking initiatives to expand our franchise, providing superior service and developing meaningful customer relationships.

Assets grew 16.5% supported by deposit growth of 20.1%. These deposits funded loan growth of 18.9%. We brought our brand of community banking to three new communities by opening de novo branches in Southbury, Waterbury and Cheshire, Connecticut. We are pleased with the initial growth of these new branches and our acceptance in our new communities. Noninterest income increased 28.4% as new fee based programs such as reverse mortgages and an overdraft privilege program were delivered by our dedicated and experienced employees. Our loan delinquencies remained low due to our continued dedication to credit quality.

Earnings decreased in 2006 due to the challenging interest rate environment and as a result of the costs of our growth. We understand and remain focused on what it takes to build value within the Mutual Holding Company structure. The market rewarded our share holders with a 20% increase in our stock price and we built value through the repurchase of 131,150 shares or 34.5% of the total shares authorized to be repurchased under the announced program. We increased the amount of our quarterly dividend from \$.04 to \$.05 per share starting with the first quarterly dividend paid in 2006.

Finally, in 2006 the Naugatuck Valley Savings and Loan Foundation, the charitable foundation we established and funded with our common stock in connection with the 2004 stock offering, made grants in excess of \$98,000 to support charitable and humanitarian needs in our community.

We thank you for your continued support as we strive for continued growth and success.

Sincerely Yours,

A handwritten signature in black ink, appearing to read "Ronald D. Lengyel".

Ronald D. Lengyel
Chairman of the Board

A handwritten signature in black ink, appearing to read "John C. Roman".

John C. Roman
President and CEO

Selected Consolidated Financial and Other Data

The following table sets forth certain consolidated summary historical financial information concerning the financial position of Naugatuck Valley Financial and its subsidiary, Naugatuck Valley Savings, at the dates and for the periods indicated. The financial data is derived in part from, and should be read in conjunction with, the consolidated financial statements and related notes of Naugatuck Valley Financial appearing later in this annual report.

	At December 31,				
	2006	2005	2004	2003	2002
	(In thousands)				
Financial Condition Data:					
Total assets	\$413,855	\$355,346	\$265,449	\$243,956	\$227,998
Securities held to maturity	2,531	5,002	5,168	1,561	1,364
Securities available for sale	67,736	58,047	31,096	37,166	32,512
Loans receivable, net	308,376	259,427	203,820	180,378	166,046
Cash and cash equivalents	7,942	8,951	7,575	9,775	18,158
Deposits	289,198	240,846	193,366	183,455	173,231
FHLB advances	68,488	57,059	15,826	34,990	31,119
Total capital	51,084	50,964	51,571	21,217	19,850

	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(In thousands, except per share data)				
Operating Data:					
Interest and dividend income	\$20,750	\$15,908	\$12,713	\$12,644	\$13,178
Interest expense	<u>9,350</u>	<u>4,941</u>	<u>3,559</u>	<u>4,241</u>	<u>5,299</u>
Net interest income	11,400	10,967	9,154	8,403	7,879
Provision for loan losses	<u>192</u>	<u>32</u>	<u>—</u>	<u>45</u>	<u>231</u>
Net interest income after provision for loan losses	11,208	10,935	9,154	8,358	7,648
Noninterest income	1,948	1,517	1,078	1,115	972
Noninterest expense	<u>11,504</u>	<u>10,097</u>	<u>9,803</u>	<u>6,845</u>	<u>5,820</u>
Income before provision for income taxes	1,652	2,355	429	2,628	2,800
Provision for income taxes	<u>204</u>	<u>450</u>	<u>14</u>	<u>822</u>	<u>880</u>
Net income	<u>\$ 1,448</u>	<u>\$ 1,905</u>	<u>\$ 415</u>	<u>\$ 1,806</u>	<u>\$ 1,920</u>
Earnings per share, basic and diluted	<u>\$ 0.20</u>	<u>\$ 0.26</u>	<u>\$ 0.07⁽¹⁾</u>	NA	NA

(1) Net income per share is for the fourth quarter 2004. Before September 30, 2004, Naugatuck Valley Financial did not exist and Naugatuck Valley Savings operated as a mutual institution and, accordingly, had no per share data.

	At or For the Year Ended December 31,				
	2006	2005	2004	2003	2002
Performance Ratios:					
Return on average assets	0.38%	0.62%	0.16%	0.77%	0.91%
Return on average equity	2.79	3.66	1.42	8.59	10.23
Interest rate spread (1)	3.07	3.68	3.78	3.77	3.77
Net interest margin (2)	3.26	3.87	3.85	3.85	3.90
Noninterest expense to average assets	3.03	3.27	3.81	2.94	2.75
Efficiency ratio (3)	85.93	80.61	95.47	71.62	65.20
Dividend payout ratio (4)	100.00	61.54	—	—	—
Average interest-earning assets to average interest-bearing liabilities	107.18	111.20	104.98	103.69	105.20
Average equity to average assets	13.65	16.87	11.37	9.02	8.86
Capital Ratios:					
Total capital to risk-weighted assets	14.29	17.88%	23.61%	16.21%	15.37%
Tier 1 capital to risk-weighted assets	13.56	17.07	22.52	14.96	14.12
Tier 1 capital to adjusted total assets (5)	9.53	11.42	14.78	8.64	8.30
Total equity to total assets	12.34	14.34	19.43	8.70	8.71
Asset Quality Ratios:					
Allowance for loan losses as a percent of total loans	0.67%	0.72%	0.89%	0.99%	1.19%
Allowance for loan losses as a percent of nonperforming loans	103.03	638.78	306.88	199.78	162.91
Net charge-offs (recoveries) to average loans outstanding during the period	0.00	0.01	(0.01)	0.13	0.05
Nonperforming loans as a percent of total loans	0.65	0.11	0.29	0.50	0.73
Nonperforming assets as a percent of total assets	0.49	0.10	0.25	0.46	0.58
Other Data:					
Number of:					
Deposit accounts	27,385	25,592	22,599	22,447	22,059
Full service customer service facilities	9	6	5	5	4

- (1) Represents the difference between the weighted average yield on average interest-earning assets and the weighted average cost of interest-bearing liabilities.
- (2) Represents net interest income as a percent of average interest-earning assets.
- (3) Represents noninterest expense (less intangible amortization) divided by the sum of net interest income and noninterest income.
- (4) Represents dividends declared per share divided by basic net income per share.
- (5) Data for 2003 represents Tier 1 capital to average assets.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The objective of this section is to help the reader understand our views on our financial condition and results of operations. You should read this discussion in conjunction with the consolidated financial statements and notes to the financial statements that appear at the end of this annual report.

Overview

Income. We have two primary sources of income. The first is net interest income, which is the difference between interest income, the income that we earn on our loans and investments, and interest expense, the interest that we pay on our deposits and borrowings.

To a lesser extent, we also recognize income from fees and service charges, which is the compensation we receive from providing products and services. Our primary noninterest income comes from fees and service charges on loan and deposit accounts. We also earn income from bank owned life insurance, sales of loans and investments and investment advisory services.

Expenses. The expenses we incur in operating our business consist of compensation, taxes and benefits, office occupancy, computer processing fees, advertising and professional fees and other expenses.

Compensation, taxes and benefits consist primarily of the salaries and wages paid to our employees and directors, payroll taxes and expenses for retirement and other employee benefits.

Occupancy expenses, which are the fixed and variable costs of buildings and equipment, consist primarily of lease payments, real estate taxes, depreciation charges, maintenance, and costs of utilities.

Computer processing fees includes fees paid to our third-party data processing servicer and our network security expenses.

Professional fees include fees paid for our attorneys, accountants and consultants.

Other expenses include expenses for insurance (including Federal Deposit Insurance Corporation insurance), postage, expenses associated with being a public company, expenses related to checking accounts, supervisory examinations and other miscellaneous operating activities.

Critical Accounting Policies

We consider accounting policies involving significant judgments and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. We consider the following to be critical accounting policies: allowance for loan losses and deferred income taxes.

Allowance for Loan Losses. Determining the amount of the allowance for loan losses necessarily involves a high degree of judgment. Management reviews the level of the allowance on a quarterly basis, at a minimum, and establishes the provision for loan losses based on the composition of the loan portfolio, delinquency levels, loss experience, economic conditions, and other factors related to the collectibility of the loan portfolio.

Although we believe that we use the best information available to establish the allowance for loan losses, future additions to the allowance may be necessary based on estimates that are susceptible to change as a result of changes in economic conditions and other factors. We engage an independent review of our commercial loan portfolio annually and adjust our loan ratings based upon this review. In addition, our banking regulators as an integral part of their examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize adjustments to the allowance based on its judgments about information available to it at the time of its examination. See notes 2 and 4 of the notes to the financial statements included in this annual report.

Deferred Income Taxes. We use the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. We exercise significant judgment in evaluating the amount and timing of recognition of the resulting tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed periodically as regulatory and business factors change. See note 11 of the notes to the financial statements in this annual report.

Operating Strategy

At Naugatuck Valley Financial Corporation we pursue a strategy which is focused on long-term growth by providing superior customer service and the profitable delivery of the products our customers want.

The successful pursuit of this strategy involves growth of deposits and loans, increases in non-interest income, maintenance of credit quality, branch improvement and expansion of our market area.

During 2006, we grew deposits by competing aggressively on rate and marketing free checking products. We were also successful in building municipal deposits from towns and cities in our market area, through the creation of a competitively priced Municipal Deposit product.

We grew loans of all types by meeting rate competition and through the sales efforts of our experienced business development teams. We increased residential mortgage loans by offering competitive rates and superior customer service from the time of application through closing and servicing. Our 2006 Home Equity Loan and Line promotion successfully grew both fixed and variable rate consumer loans. We successfully increased commercial mortgages and residential development loans through the efforts of our business development officers who build relationships and understand our borrowers, businesses and the communities they operate in.

We strive to decrease reliance on net interest income by increasing our sources and the amount of non-interest income. We continue to build non-interest income by increasing income from overdraft protection services, reverse mortgages and brokerage income from the sale of mortgages that do not meet our underwriting standards. We expect non-interest income to continue to rise in the future through the lease of office and retail space available at our Seymour and Southbury offices and through increases in income from investment advisory services and sales of Savings Bank Life Insurance.

We continue to be dedicated to the maintenance of credit quality. We maintained strong credit standards as we grew loans in the first half of this decade and expect our loan portfolios to maintain their low delinquency levels. We are committed to the maintenance of adequate loan loss reserves and prudently increased our loan loss reserves in 2006.

During 2006, we took advantage of opportunities to expand our geographic reach by opening de novo branches. Our Southbury office was constructed on bank owned property during the first half of 2006 and opened for business in August 2006. In the summer of 2006, we took advantage of opportunities to enter the Waterbury and Cheshire markets through the lease of bank offices recently abandoned by our competition due to bank consolidations. We will continue to upgrade our current branch facilities and pursue expansion of our branch system in future years through de novo branching and branch acquisitions.

Historically, we have pursued a strategy of maintaining a high loan-to-asset ratio. This strategy requires us to prudently deploy our sources of funds, primarily deposits, into new loans. As of December 31, 2006, our loan to asset ratio was 75%, up from 73% as of December 31, 2005. In spite of the inverted yield curve, we increased our net interest income by successfully managing asset and liability growth. This was accomplished by growing deposits and investing the funds in high quality residential mortgages, consumer lines of credit and small business and development loans.

We utilize a number of tools to increase net interest income and decrease interest rate risk. These tools include the purchase of short-term investments and the pursuit of a leverage strategy under which we fund our investments with lower cost borrowings.

Balance Sheet

Loans. Our principal lending activity is the origination of loans secured by real estate primarily located in our market area. We originate real estate loans secured by one- to four-family residential homes and multi-family and commercial real estate and construction loans. At December 31, 2006, real estate loans totaled \$255.4 million, or 81.5% of total loans compared to \$215.5 million, or 81.6% of total loans at December 31, 2005 and \$174.8 million, or 84.0% of total loans at December 31, 2004. Real estate loans have increased due to the stable interest rates together with significant real estate development in our market area.

The largest segment of our real estate loans is one- to four-family residential loans. At December 31, 2006, these loans totaled \$179.4 million and represented 70.2% of real estate loans and 57.3% of total loans compared to \$156.9 million, which represented 72.8% of real estate loans and 59.4% of total loans, at December 31, 2005. One- to four-family residential loans increased \$22.5 million, or 14.3%, from December 31, 2005 to December 31, 2006 and increased \$22.1 million, or 16.4%, from December 31, 2004 to December 31, 2005, reflecting a growth in the mortgage portfolio from new borrowers and refinancing of existing customers.

Multi-family and commercial real estate loans are the second largest segment of our real estate loan portfolio. This portfolio was \$45.9 million and represented 18.0% of real estate loans and 14.6% of total loans at December 31, 2006 compared to \$33.6 million, which represented 15.6% of real estate loans and 12.7% of total loans, at December 31, 2005. Multi-family and commercial real estate loans increased \$12.3 million, or 36.5%, for the year ended December 31, 2006 and \$11.0 million, or 49.0%, in the year ended December 31, 2005 due to the efforts on the part of our business development officers to grow market share and attract new customers.

We also originate construction loans secured by residential and commercial real estate. This portfolio was \$30.1 million and represented 11.8% of real estate loans and 9.6% of total loans at December 31, 2006 compared to \$24.9 million, which represented 11.6% of real estate loans and 9.5% of total loans at December 31, 2005. Construction loans increased \$5.2 million, or 20.8%, for the year ended December 31, 2006 and \$7.4 million, or 42.6%, in the year ended December 31, 2005 primarily due to an increased demand by contractors for construction loans and an increase in demand for construction to permanent financing by commercial customers.

We originate commercial business loans secured by business assets other than real estate, such as business equipment, inventory and accounts receivable and letters of credit. Commercial business loans totaled \$13.5 million, and represented 4.3% of total loans at December 31, 2006, compared to \$9.7 million, representing 3.7% of total loans, at December 31, 2005.

We also originate a variety of consumer loans, including second mortgage loans, home equity lines of credit and loans secured by savings accounts and automobiles. Consumer loans totaled \$44.3 million and represented 14.2% of total loans at December 31, 2006, compared to \$38.8 million, which represented 14.7% of total loans at December 31, 2005. The \$5.5 million, or 14.3%, increase for the year ended December 31, 2006 and the \$10.5 million, or 36.9%, increase for the 2005 fiscal year was due to an aggressive marketing campaign together with competitive pricing on our equity loan and equity line of credit products.

The following table sets forth the composition of our loan portfolio at the dates indicated.

	At December 31,													
	2006		2005		2004		2003		2002					
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Percent			
	(Dollars in thousands)													
Real estate loans:														
One-to four-family	\$179,374	57.27%	\$156,900		59.44%	\$134,785		64.75%	\$131,353		70.98%	\$132,134		77.85%
Construction	30,124	9.62	24,943		9.45	17,486		8.40	14,094		7.62	6,888		4.06
Multi-family and commercial real estate	45,879	14.65	33,608		12.73	22,559		10.84	14,273		7.71	10,285		6.06
Total real estate loans	255,377	81.54	215,451		81.62	174,830		83.99	159,720		86.31	149,307		87.97
Commercial business loans	13,508	4.31	9,728		3.69	4,989		2.40	4,240		2.29	1,693		1.00
Consumer loans:														
Savings accounts	634	0.20	785		0.30	679		0.33	592		0.32	519		0.31
Personal	275	0.09	212		0.08	217		0.10	139		0.08	153		0.09
Automobile	186	0.06	160		0.06	98		0.05	143		0.08	181		0.11
Home equity	43,220	13.80	37,628		14.25	27,342		13.13	20,212		10.92	17,873		10.53
Total consumer loans	44,315	14.15	38,785		14.69	28,336		13.61	21,086		11.40	18,726		11.03
Total loans	313,200	100.00%	263,964		100.00%	208,155		100.00%	185,046		100.00%	169,726		100.00%
Less:														
Allowance for loan losses	2,071		1,878			1,829			1,810			1,994		
Undisbursed construction loans	2,343		2,258			2,094			2,519			1,168		
Deferred loan origination fees	410		401			412			339			518		
Loans receivable, net	\$308,376		\$259,427			\$203,820			\$180,378			\$166,046		

The following table sets forth certain information at December 31, 2006 regarding the dollar amount of loans repricing or maturing during the periods indicated. The table does not include any estimate of prepayments which significantly shorten the average life of all loans and may cause our actual repayment experience to differ from that shown below. Demand loans having no stated maturity are reported as due in one year or less.

	At December 31, 2006			
	Real Estate Loans	Commercial Business Loans	Consumer Loans	Total Loans
	(In thousands)			
One year or less	\$31,483	\$6,458	\$21,967	\$59,908
More than one year to five years.....	49,420	5,241	1,572	56,233
More than five years	174,474	1,809	20,776	197,059
Total.....	<u>\$255,377</u>	<u>\$13,508</u>	<u>\$44,315</u>	<u>\$313,200</u>

The following table sets forth the dollar amount of all loans at December 31, 2006 that are due after December 31, 2007 and have either fixed interest rates or floating or adjustable interest rates. The amounts shown below exclude applicable loans in process, nonperforming loans and deferred loan fees, net.

	Fixed-Rates	Floating or Adjustable- Rates	Total
	(In thousands)		
Real estate loans:			
One- to four-family.....	\$145,260	\$30,360	\$175,620
Construction.....	5,947	1,013	6,960
Multi-family and commercial	4,620	36,694	41,314
Commercial business loans.....	3,187	3,863	7,050
Consumer loans	22,282	66	22,348
Total.....	<u>\$181,296</u>	<u>\$71,996</u>	<u>\$253,292</u>

The following table shows loan origination activity during the periods indicated.

	Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Total loans at beginning of period.....	\$263,964	\$208,155	\$185,046
Loans originated:			
Real estate loans:			
One- to four-family	35,330	42,144	30,002
Construction	27,288	27,695	20,598
Multi-family and commercial.....	15,672	23,389	10,865
Commercial business loans	8,172	6,308	3,962
Consumer loans	22,651	24,664	18,416
Total loans originated	109,113	124,200	83,843
Loans purchased.....	—	—	—
Deduct:			
Real estate loan principal repayments	(38,364)	(52,607)	(44,622)
Loan sales.....	—	—	(1,927)
Other repayments	(21,513)	(15,784)	(14,185)
Net loan activity	49,236	55,809	23,109
Total loans at end of period.....	<u>\$313,200</u>	<u>\$263,964</u>	<u>\$208,155</u>

Allowance for Loan Losses and Asset Quality. The allowance for loan losses is a valuation allowance for the probable losses inherent in the loan portfolio. We evaluate the need to establish allowances against losses on loans on a quarterly basis. When additional allowances are needed a provision for loan losses is charged against earnings. The recommendations for increases or decreases to the allowance are presented by management to the Board of Directors on a quarterly basis.

The allowance for loan losses is established to recognize the inherent losses associated with lending activities. Loss and risk factors are based on our historical loss experience and industry averages and may be adjusted for significant factors that in management's judgment affect the collectibility of the portfolio as of the evaluation date. These significant factors may include changes in lending policies and procedures, changes in existing general economic and business conditions affecting our primary lending area, credit quality trends, collateral value, loan volumes and concentrations, seasoning of the loan portfolio, specific industry conditions within portfolio segments, recent loss experience in particular segments of the portfolio, duration of the current business cycle, and bank regulatory examination results.

Our methodology for assessing the appropriateness of the allowance for loan losses consists of the following procedures. The loan portfolio is segregated first between passed and classified assets.

Passed Assets. Our assets designated as pass or bankable with care by our internal classification system are aggregated by loan category and an allowance percentage is assigned based on estimated inherent losses associated with each type of lending. Our passed and bankable with care assets are loans for which the borrower is established and represents a reasonable credit risk.

We retain a general loan loss allowance on loans classified as passed. This portion of our allowance is determined based on our historical loss experience, delinquency trends, and management's evaluation of the loan portfolio and may be adjusted for significant factors that in management's judgment affect the collectibility of the portfolio as of the evaluation date. These significant factors may include changes in general economic and business conditions affecting our primary lending areas, credit quality trends, collateral value, loan volumes and concentrations, seasoning of the loan portfolio, recent loss experience in particular segments of the portfolio, duration of the current business cycle and bank regulatory examination results. These factors are reviewed regularly to ensure their relevance in the prevailing business environment.

Classified Assets. Our assets classified internally as special mention, substandard or doubtful (all regulatory classifications for problem assets) by our internal classification system are individually evaluated by management and an allowance percentage, increasing as the probability of loss increases, is assigned to each classified asset based on the collateral value and loan balance. The level of the allowance percentage is further dependent on whether the loan is secured by real estate, secured by assets other than real estate or unsecured. Loans classified as loss are charged off and, if the loan is secured by real estate collateral, the real estate is transferred to foreclosed real estate.

The loss factors allowance percentages which are presently used to determine the reserve level were updated in 2006 based on various risk factors such as type of loan, collateral and loss history. These factors are subject to ongoing evaluation to ensure their relevance to our loan portfolio in the current economic environment.

When we determine that a loan is troubled and where, based on current information and events, it is probable that we will not be able to collect all amounts due, the excess of the recorded investment in the loan over the fair market value of any collateral, net of estimated costs to sell the asset, is classified as loss, and we classify the remainder of the loan balance as substandard.

We identify loans which may require charge off as a loss by reviewing all delinquent loans, significant credits, loans classified as substandard, doubtful, loss, or special mention by our internal classification system, all classified loans, and other loans that management may have concerns about collectibility, such as loans to a specific industry. For individually reviewed loans, a borrower's inability to service a credit according to the contractual terms based on the borrower's cash flow and or a shortfall in collateral value would result in the recording of a charge off of the loan or the portion of the loan that was impaired.

Our banking regulators, as an integral part of their examination process, periodically review our allowance for loan losses. The examinations may require us to make additional provisions for loan losses based on judgments different from ours. In addition, we engage an independent consultant to review our commercial loan portfolio and make recommendations based on their review as to the classification of specific credits in the portfolio.

The following table sets forth the breakdown of the allowance for loan losses based on the components of our allowance at the dates indicated.

	At December 31, 2006	At December 31, 2005
	(In thousands)	
Passed assets	\$1,711	\$1,425
Classified assets	360	450
Unallocated	-	3
Total	<u>\$2,071</u>	<u>\$1,878</u>

At December 31, 2006, our allowance for loan losses represented 0.67% of total gross loans and 103.3% of nonperforming loans. The allowance for loan losses increased \$193,000 from December 31, 2005 to December 31, 2006. The increase in the allowance was the result of net recoveries and provisions for loan losses.

At December 31, 2005, our allowance for loan losses represented 0.72% of total gross loans and 638.78% of nonperforming loans. The allowance for loan losses increased \$49,000 from December 31, 2004 to December 31, 2005. The increase in the allowance was the result of net recoveries and provisions for loan losses.

Total nonperforming loans increased during the year ended December 31, 2006 due to the migration of a large relationship into nonaccrual. The Company recorded a provision for loan losses of \$192,000 during the year ended December 31, 2006 and a provision of \$32,000 during the year ended December 31, 2005.

Although we believe that we use the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses may be necessary and results of operations could be adversely affected if circumstances differ substantially from the assumptions used in making the determinations. Furthermore, while we believe we have established our allowance for loan losses in conformity with generally accepted accounting principles, there can be no assurance that regulators, in reviewing our loan portfolio, will not request us to increase our allowance for loan losses. In addition, because further events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that increases will not be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses may adversely affect our financial condition and results of operations.

Summary of Loan Loss Experience. The following table sets forth an analysis of the allowance for loan losses for the periods indicated. Where specific loan loss allowances have been established, any difference between the loss allowance and the amount of loss realized has been charged or credited to current income.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Allowance at beginning of period	<u>\$1,878</u>	<u>\$1,829</u>	<u>\$1,810</u>	<u>\$1,994</u>	<u>\$1,856</u>
Provision for loan losses	192	32	—	45	231
Less: Charge offs:					
Real estate loans	—	—	—	265	112
Commercial business loans	—	3	51	—	—
Consumer loans	<u>2</u>	<u>1</u>	<u>5</u>	<u>2</u>	<u>5</u>
Total charge-offs	<u>2</u>	<u>4</u>	<u>56</u>	<u>267</u>	<u>117</u>
Plus: Recoveries:					
Real estate loans	3	18	43	38	23
Commercial business loans	—	3	—	—	—
Consumer loans	—	—	32	—	1
Total recoveries	<u>3</u>	<u>21</u>	<u>75</u>	<u>38</u>	<u>24</u>
Net charge-offs (recoveries)	<u>(1)</u>	<u>(17)</u>	<u>(19)</u>	<u>229</u>	<u>93</u>
Allowance at end of period	<u>\$2,071</u>	<u>\$1,878</u>	<u>\$1,829</u>	<u>\$1,810</u>	<u>\$1,994</u>
Allowance to nonperforming loans	103.03%	638.78%	306.88%	199.78%	162.91%
Allowance to total loans outstanding at the end of the period	0.67%	0.72%	0.89%	0.99%	1.19%
Net charge-offs (recoveries) to average loans outstanding during the period	0.00%	0.01%	(0.01)%	0.13%	0.05%

The following table sets forth the breakdown of the allowance for loan losses by loan category at the dates indicated.

	At December 31,								
	2006			2005			2004		
	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans
	(Dollars in thousands)								
One- to four-family	\$ 718	34.67%	57.27%	\$ 724	38.55%	59.44%	\$ 864	47.25%	64.75%
Construction	464	22.40	9.62	376	20.02	9.45	142	7.76	8.40
Multi-family and commercial real estate	347	16.76	14.65	379	20.18	12.73	374	20.45	10.84
Commercial business	209	10.09	4.31	113	6.02	3.69	50	2.73	2.40
Consumer loans	333	16.08	14.15	283	15.07	14.69	302	16.51	13.61
Unallocated	—	—	—	3	0.16	—	97	5.30	—
Total allowance for loan losses ..	<u>\$2,071</u>	<u>100.00%</u>	<u>100.00%</u>	<u>\$1,878</u>	<u>100.00%</u>	<u>100.00%</u>	<u>\$1,829</u>	<u>100.00%</u>	<u>100.00%</u>

At December 31,						
2003			2002			
	% of	% of		% of	% of	
	Allowance	Loans in		Allowance	Loans in	
	to Total	Category		to Total	Category	
Amount	Allowance	to Total	Amount	Allowance	to Total	Loans
		Loans			Loans	
(Dollars in thousands)						
One- to four-family	\$ 927	51.22%	70.98%	\$1,566	78.54%	77.85%
Construction	185	10.22	7.62	100	5.02	4.06
Multi-family and commercial real estate	321	17.73	7.71	148	7.42	6.06
Commercial business	92	5.08	2.29	59	2.96	1.00
Consumer loans	232	12.82	11.40	78	3.91	11.03
Unallocated	53	2.93	—	43	2.16	—
Total allowance for loan losses	<u>\$1,810</u>	<u>100.00%</u>	<u>100.00%</u>	<u>\$1,994</u>	<u>100.00%</u>	<u>100.00%</u>

Nonperforming and Classified Assets. When a loan becomes 90 days delinquent, the loan is placed on nonaccrual status at which time the accrual of interest ceases, the interest previously accrued to income is reversed and the loan is placed on a cash basis. Payments on a nonaccrual loan are applied to the outstanding principal and interest as determined at the time of collection of the loan.

We consider repossessed assets and loans that are 90 days or more past due to be nonperforming assets. Real estate that we acquire as a result of foreclosure or by deed-in-lieu of foreclosure is classified as foreclosed real estate until it is sold. When property is acquired it is recorded at the lower of its cost, which is the unpaid balance of the loan, or fair market value at the date of foreclosure. Holding costs and declines in fair value after acquisition of the property are charged against income.

Nonperforming assets totaled \$2.0 million, or 0.49% of total assets, at December 31, 2006, which was an increase of \$1.7 million, or 489.4%, from December 31, 2005. Nonaccrual loans accounted for 100% of the total nonperforming assets at December 31, 2006. At December 31, 2006, \$106,000 of the allowance for loan losses was related to nonaccrual real estate loans.

Nonperforming assets totaled \$341,000, or 0.10% of total assets, at December 31, 2005, which was a decrease of \$323,000, or 48.6%, from December 31, 2004. Nonaccrual loans accounted for 86.2% of the total nonperforming assets at December 31, 2005. At December 31, 2005, \$40,000 of the allowance for loan losses was related to nonaccrual real estate loans.

Under current accounting guidelines, a loan is defined as impaired when, based on current information and events, it is probable that the creditor will be unable to collect all amounts due under the contractual terms of the loan agreement. We consider one- to four-family mortgage loans and consumer loans to be homogeneous and only evaluate them for impairment separately when they are delinquent or classified. Other loans are evaluated for impairment on an individual basis. At December 31, 2006, two loans were considered impaired.

The following table provides information with respect to our nonperforming assets at the dates indicated. We did not have any troubled debt restructurings or any accruing loans past due 90 days or more at the dates presented.

	At December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Nonaccrual loans:					
One- to four-family	\$ 423	\$ 165	\$ 474	\$ 500	\$1,041
Multi-family and commercial real estate.....	1,388	120	119	315	117
Commercial business.....	142	9	3	15	—
Consumer	57	—	—	76	66
Total	2,010	294	596	906	1,224
Foreclosed real estate	—	47	68	208	108
Total nonperforming assets	<u>\$ 2,010</u>	<u>\$ 341</u>	<u>\$ 664</u>	<u>\$1,114</u>	<u>\$1,332</u>
Total nonperforming loans to total loans.....	0.65%	0.11%	0.29%	0.50%	0.73%
Total nonperforming loans to total assets.....	0.49%	0.08%	0.22%	0.37%	0.54%
Total nonperforming assets to total assets.....	0.49%	0.10%	0.25%	0.46%	0.58%

Other than disclosed above, there are no other loans at December 31, 2006 that we have serious doubts about the ability of the borrowers to comply with the present loan repayment terms.

Interest income that would have been recorded for the years ended December 31, 2006 and December 31, 2005 had nonaccruing loans been current according to their original terms amounted to \$68,200 and \$20,900, respectively. Income related to nonaccrual loans included in interest income for the years ended December 31, 2006 and December 31, 2005 amounted to \$125,400 and \$19,600, respectively.

Federal regulations require us to regularly review and classify our assets. In addition, our regulators have the authority to identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. "Substandard assets" must have one or more defined weaknesses and are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. "Doubtful assets" have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified "loss" is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. The regulations also provide for a "special mention" category, described as assets which do not currently expose us to a sufficient degree of risk to warrant classification but do possess credit deficiencies or potential weaknesses deserving our close attention. When we classify an asset as substandard or doubtful, we must establish a general allowance for loan losses. If we classify an asset as loss, we must charge off such amount.

The following table shows the aggregate amounts of our classified assets at the dates indicated.

	At December 31,	
	2006	2005
	(In thousands)	
Special mention assets	\$6,899	\$5,197
Substandard assets	3,137	1,360
Doubtful assets	4	10
Loss assets	—	—
Total classified assets	<u>\$10,040</u>	<u>\$6,567</u>

Special mention assets at December 31, 2006 and December 31, 2005 did not include any nonaccrual loans. Substandard assets at December 31, 2006 and December 31, 2005 included nonaccrual loans of \$2.0 million and \$284,000, respectively. All doubtful assets at December 31, 2006 and December 31, 2005 were nonaccrual loans and all loss assets at December 31, 2006 were nonaccrual loans.

Delinquencies. The following table provides information about delinquencies in our loan portfolios at the dates indicated.

	At December 31,					
	2006		2005		2004	
	30-59	60-89	30-59	60-89	30-59	60-89
	Days	Days	Days	Days	Days	Days
	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due
	(In thousands)					
One- to four-family	\$413	\$392	\$792	\$498	\$2,017	\$581
Multi-family and commercial real estate	603	664	—	—	510	150
Commercial business	262	310	164	—	64	15
Consumer loans	—	5	7	—	135	12
Total	<u>\$1,278</u>	<u>\$1,371</u>	<u>\$963</u>	<u>\$498</u>	<u>\$2,726</u>	<u>\$758</u>

Securities. Our securities portfolio consists primarily of mortgage-backed securities and collateralized mortgage obligations with maturities of 30 years or less, municipal obligations with maturities of 15 years or less, money market preferred obligations, as well as U.S. Government and agency obligations. Securities increased by \$7.2 million in the year ended December 31, 2006 primarily due to the purchase of securities funded through Federal Home Loan Bank advances and excess liquidity. Securities increased by \$26.8 million in the year ended December 31, 2005 primarily due to the purchase of securities funded primarily through Federal Home Loan Bank advances. Substantially all of our mortgage-backed securities and collateralized mortgage obligations were issued either by Ginnie Mae, Fannie Mae or Freddie Mac. Our securities portfolio also includes a private label collateralized mortgage obligation and, to a lesser extent, corporate obligations and interest-bearing balances (certificates of deposits) at other institutions. The interest-bearing balances are all held to maturity and all mature within two years.

The following table sets forth the amortized costs and fair values of our securities portfolio at the dates indicated.

	At December 31,					
	2006		2005		2004	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)					
Available-for-sale securities:						
U.S. Government and agency obligations	\$8,495	\$8,415	\$15,344	\$15,175	\$15,072	\$15,210
Mortgage-backed securities	25,111	24,782	22,544	22,082	12,249	12,092
Collateralized mortgage obligations	4,796	4,694	4,199	4,098	3,812	3,794
Municipal obligations	15,177	15,190	8,715	8,769	—	—
Money market preferred obligations	12,700	12,700	6,000	6,000	—	—
Corporate obligations	1,951	1,955	1,928	1,923	—	—
Held-to-maturity securities:						
U.S. Government and agency obligations	1,201	1,192	1,202	1,189	703	708
Interest-bearing balances	<u>1,330</u>	<u>1,330</u>	<u>3,800</u>	<u>3,800</u>	<u>4,465</u>	<u>4,465</u>
Total	<u>\$70,761</u>	<u>\$70,258</u>	<u>\$63,732</u>	<u>\$63,036</u>	<u>\$36,301</u>	<u>\$36,269</u>

At December 31, 2006, we did not own any securities, other than U.S. Government and agency securities, that had an aggregate book value in excess of 10% of our total capital at that date.

The following table sets forth the final maturities and weighted average yields of securities at December 31, 2006. Mortgage-backed securities and collateralized mortgage obligations are secured by mortgages and as a result produce monthly principal repayments which are not reflected in the table below. Certain mortgage-backed securities, collateralized mortgage obligations and money market preferred obligations have adjustable interest rates and reprice within the various maturity ranges. These repricing schedules are not reflected in the table below. At December 31, 2006, mortgage-backed securities and collateralized mortgage obligations with adjustable rates totaled \$19.3 million.

	Less Than One Year		More than One Year to Five Years		More than Five Years to Ten Years		More than Ten Years		Total	
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield
(Dollars in thousands)										
Available-for-sale securities:										
U.S. Government and agency obligations	\$ 3,962	3.77%	\$ 3,473	4.56%	\$ 980	5.80%	\$ —	—%	\$ 8,415	4.33%
Mortgage-backed securities	—	—	1,533	3.69	—	—	23,249	4.84	24,782	4.77
Collateralized mortgage obligations	—	—	—	—	982	5.28	3,712	4.27	4,694	4.48
Municipal obligations	999	3.68	—	—	830	4.03	13,361	4.25	15,190	4.20
Money market preferred obligations	12,700	4.42	—	—	—	—	—	—	12,700	4.42
Corporate obligations	—	—	1,955	5.21	—	—	—	—	1,955	5.21
Total available-for-sale securities	17,661	4.23	6,961	4.55	2,792	5.09	40,322	4.59	67,736	4.51
Held-to-maturity securities:										
U.S. Government and agency obligations	1,201	4.10	—	—	—	—	—	—	1,201	4.10
Interest-bearing balances	1,140	3.06	190	3.75	—	—	—	—	1,330	3.16
Total held-to-maturity securities	2,341	3.59	190	3.75	—	—	—	—	2,531	3.61
Total	\$20,002	4.16	\$7,151	4.53	\$2,792	5.09	\$40,322	4.59	\$70,267	4.48

Bank Owned Life Insurance. During 2003, we purchased life insurance policies on certain key executives. We purchased \$2.5 million of additional policies in the fourth quarter of 2005. Bank owned life insurance is recorded as an asset at the lower of its cash surrender value or the amount that can be realized. Income earned on bank owned life insurance policies is exempt from income taxes.

Deposits. Our primary source of funds is retail deposit accounts held principally by individuals and businesses within our market area. The deposit base is comprised of certificate accounts, regular savings accounts, checking and NOW accounts, money market savings accounts and health savings accounts. At December 31, 2006, we had no brokered deposits. Total deposits increased \$48.4 million or 20.1% in the year ended December 31, 2006. During that time period, certificate accounts increased 34.8%, regular savings accounts decreased by 10.2%, checking and NOW accounts increased by 22.4% and money market deposit accounts increased by 2.2%. The increases in our deposit accounts were primarily due to increased advertising and more aggressive pricing, partially related to the opening of our three new branch offices in 2006. The decrease in regular savings accounts was primarily due to the transfer of funds to other savings products with higher rates.

The following table sets forth the balances of our deposit products at the date indicated.

	At December 31,		
	2006	2005	2004
	(In thousands)		
Certificate accounts	\$ 165,076	\$ 122,431	\$ 81,200
Regular savings accounts.....	46,156	51,375	43,941
Checking and NOW accounts.....	57,301	46,825	37,003
Money market savings accounts	<u>20,665</u>	<u>20,215</u>	<u>31,222</u>
Total.....	<u>\$289,198</u>	<u>\$240,846</u>	<u>\$193,366</u>

The following table indicates the amount of jumbo certificate accounts by time remaining until maturity at December 31, 2006. Jumbo certificate accounts require minimum deposits of \$100,000.

<u>Maturity Period</u>	<u>Certificate Accounts</u> (In thousands)
Three months or less	\$ 9,042
Over three through six months.....	15,089
Over six through twelve months	19,490
Over twelve months	<u>4,607</u>
Total	<u>\$48,228</u>

The following table sets forth the certificate accounts classified by rates at the dates indicated.

	At December 31,		
	2006	2005	2004
	(In thousands)		
0.00 - 0.99%.....	\$ 805	\$ 2,416	\$13,094
1.00 - 1.99	11,863	17,633	31,371
2.00 - 2.99	3,138	16,699	14,704
3.00 - 3.99	17,866	50,729	14,228
4.00 - 4.99	60,207	34,954	6,884
5.00 - 5.99	<u>71,197</u>	<u>—</u>	<u>919</u>
Total.....	<u>\$165,076</u>	<u>\$122,431</u>	<u>\$81,200</u>

The following table sets forth the amount and maturities of certificate accounts at December 31, 2006.

	Amount Due					Percent of Total Certificate Accounts
	Less Than One Year	More Than One Year to Two Years	More Than Two Years to Three Years	More Than Three to Four Years	More Than Four Years	
	(Dollars in thousands)					
0.00 - 0.99%	\$ 805	\$ —	\$ —	\$ —	\$ —	0.49%
1.00 - 1.99	10,068	1,573	222	—	—	7.19
2.00 - 2.99	2,193	604	341	—	—	1.90
3.00 - 3.99	9,543	5,824	1,991	508	—	10.82
4.00 - 4.99	52,565	3,705	920	2,863	154	36.47
5.00 - 5.99	69,882	1,315	—	—	—	43.13
Total	<u>\$145,056</u>	<u>\$13,021</u>	<u>\$3,474</u>	<u>\$3,371</u>	<u>\$ 154</u>	100.00%

The following table sets forth the savings activity for the periods indicated.

	Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Beginning balance	\$240,846	\$193,366	\$183,455
Increase before interest credited	41,811	44,086	7,654
Interest credited	6,541	3,394	2,257
Net increase in savings deposits	<u>48,352</u>	<u>47,480</u>	<u>9,911</u>
Ending balance	<u>\$289,198</u>	<u>\$240,846</u>	<u>\$193,366</u>

Borrowings. We borrow funds from the Federal Home Loan Bank of Boston during periods of low liquidity to match fund increases in our fixed-rate mortgage portfolio and to provide long-term fixed-rate funding with the goal of decreasing our exposure to an increase in interest rates. In 2006 we also borrowed funds from the Federal Home Loan Bank of Boston to purchase securities. In addition, we occasionally borrow short-term from correspondent banks to cover temporary cash needs. At December 31, 2006, we had the ability to borrow a total of \$3.5 million from a correspondent bank, none of which was borrowed at such date.

The following table presents certain information regarding our Federal Home Loan Bank advances during the periods and at the dates indicated.

	Year Ended December 31,		
	2006	2005	2004
	(Dollars in thousands)		
Maximum amount of advances outstanding at any month end during the period	\$70,414	\$57,059	\$34,643
Average advances outstanding during the period	59,423	38,530	27,379
Weighted average interest rate during the period	4.69%	3.93%	4.59%
Balance outstanding at end of period	\$68,488	\$57,059	\$15,826
Weighted average interest rate at end of period	4.83%	4.20%	4.42%

Equity. Total equity increased by \$120,000, or 0.24%, to \$51.08 million at December 31, 2006 from \$50.96 million at December 31, 2005. The increase in 2006 was due to net income of \$1.4 million for the twelve-month period, stock repurchases of \$1.5 million, year-to-date dividends of \$617,000 paid to stockholders, a net decrease to the unrealized loss on available-for-sale securities of \$125,000, \$433,000 in equity adjustments related to the Company's 2005 Equity Incentive Plan and \$221,000 in equity adjustments related to the release of 19,889 shares under the Company's Employee Stock Ownership Plan. Total equity decreased by \$607,000, or 1.2%, to \$51.0 million at December 31, 2005 from \$51.6 million at December 31, 2004. The decrease in 2005 was due to net income of \$1.9 million, \$1.8 million in equity adjustments related to the Company's 2005 Equity Incentive Plan, year-to-date dividends of \$500,000 paid to stockholders, a net increase to the unrealized loss on available-for-sale securities of \$427,000 and \$218,000 in equity adjustments related to the release of 19,889 shares of our employee stock ownership plan. Our average equity to average assets ratio was 13.65% at December 31, 2006, compared to 16.87% at December 31, 2005, and 11.37% at December 31, 2004.

Comparison of Operating Results for the Years Ended December 31, 2006, 2005 and 2004

Overview.

	2006	2005	2004	% Change 2006/2005	% Change 2005/2004
	(Dollars in thousands)				
Net income	\$1,448	\$1,905	\$ 415	(23.99%)	359.04%
Return on average assets	0.38%	0.62%	0.16%	(38.71%)	287.50%
Return on average equity	2.79%	3.66%	1.42%	(23.77%)	157.75%

2006 v. 2005. Net income decreased primarily due to an increase in interest expense as the cost of our interest-bearing liabilities continued to increase more rapidly than yields on our interest-earning assets, reflecting the inverted yield curve. The increase in interest expense was also the result of the marketing of competitively priced deposit products offered in conjunction with the opening of our three new branch offices in the third quarter of 2006. We also experienced an increase in non-interest expense due to branch expansion and an increase in the reserve for loan losses as our mix of loans changes.

2005 v. 2004. Net income increased primarily due to an increase in net interest income and non-interest income. These increases were partially offset by increases in non-interest expense and increases in tax and loan loss provisions.

Net Interest Income.

2006 v. 2005. Net interest income increased \$433,000, or 3.9% to \$11.4 million for 2006. The increase in net interest income for 2006 was the result of an increase in the average balances of interest earning assets combined with an increase in the average rate earned on these assets, partially offset by increases in interest expense.

Interest and dividend income for 2006 was \$20.8 million, compared to \$15.9 million for 2005, an increase of \$4.9 million or 30.4%. The increase was the result of an increase in the average balances of interest earning assets of 23.6%, combined with an increase in the average rate earned on these assets of 31 basis points over the 2005 rates. The increase in interest earning assets is attributed primarily to an increase in the loan and investment portfolios. The average balances in the loan portfolio increased by 23.0% to \$277.8 million in 2006, up from \$225.8 million in 2005, while the average balance of investments increased by 26.6% to \$67.1 million in 2006 from \$53.0 million in 2005.

Interest expense for 2006 was \$9.3 million compared to \$4.9 million for 2005, an increase of \$4.4 million or 89.8%. This increase resulted from a 92 basis point increase in the rates paid on interest-bearing liabilities to 2.86% in 2006 from 1.94% in 2005 due to rising market rates on deposits and borrowings along with increases in the average balances of deposits and borrowings of \$71.9 million, or 28.2%, to \$326.4 million in 2006 from \$254.5

million in 2005. The increase in the average interest-bearing liabilities was due to increases in certificates of deposit, advances from the Federal Home Loan Bank, checking and escrow, partially offset by a decrease in the average balance of money market savings accounts.

2005 v. 2004. Net interest income increased \$1.8 million, or 19.8%, to \$11.0 million for 2005. The increase in net interest income for 2005 was the result of an increase in the average balances of interest earning assets combined with an increase in the average rate earned on these assets, partially offset by higher cost of funds.

Interest and dividend income for 2005 was \$15.9 million, compared to \$12.7 million for 2004, an increase of \$3.2 million, or 25.1%. This increase was the result of an increase in the average balances of interest earning assets of 19.1% combined with an increase in the average rate earned on these assets of 27 basis points over the 2004 rates. The increase in interest earning assets is attributed primarily to an increase in the loan and investment portfolios. The average balances in the loan portfolio increased by 18.4% to \$225.8 million in 2005, up from \$190.7 million in 2004, while the average balance of investments increased by 59.1% to \$53.0 million in 2005 from \$33.3 million in 2004.

Interest expense for 2005 was \$4.9 million compared to \$3.6 million for 2004, an increase of \$1.3 million or 38.8%. This increase resulted from a 37 basis point increase in the rates paid on interest-bearing liabilities to 1.94% in 2005 from 1.57% in 2004 due to rising market rates on deposits and borrowings along with increases in the average balances of deposits and borrowings of \$28.1 million, or 12.4%, to \$254.5 million in 2005 from \$226.4 in 2004. The increase in the average interest-bearing liabilities was due to increases in certificates of deposit, regular savings, checking and advances from the Federal Home Loan Bank, partially offset by a decrease in the average balance of money market savings accounts.

Average Balances and Yields. The following table presents information regarding average balances of assets and liabilities, the total dollar amounts of interest income and dividends, the total dollar amount of interest expense and the resulting average yields and costs. The yields and costs for the periods indicated are derived by dividing income or expense by the average balances of assets or liabilities, respectively, for the periods presented. For purposes of this table, average balances have been calculated using the average of daily balances and nonaccrual loans are included in average balances only. During the 2006 period, we held tax-exempt municipal securities with an average balance of \$9.7 million and preferred money market securities with an average balance of \$8.1 million which recognize a dividends received deduction. The yields below do not reflect the tax benefits of these securities.

	2006			2005			2004		
	Average Balance	Interest and Dividends	Yield/ Cost	Average Balance	Interest and Dividends	Yield/ Cost	Average Balance	Interest and Dividends	Yield/ Cost
	(Dollars in thousands)								
Interest-earning assets:									
Loans	\$277,789	\$17,506	6.30%	\$225,850	\$13,642	6.04%	\$190,713	\$11,240	5.89%
Fed Funds sold	1,407	77	5.47	1,756	56	3.19	11,726	174	1.48
Investment securities	67,077	2,976	4.44	52,987	2,102	3.97	33,307	1,245	3.74
Federal Home Loan Bank stock	3,581	191	5.33	2,481	108	4.35	1,950	54	2.77
Total interest-earning assets	349,854	20,750	5.93	283,074	15,908	5.62	237,696	12,713	5.35
Noninterest-earning assets	30,084			25,340			19,731		
Total assets	\$379,938			\$308,414			\$257,427		
Interest-bearing liabilities:									
Certificate accounts	\$ 143,007	\$ 5,613	3.92	\$ 99,487	\$ 2,772	2.79	\$ 84,890	\$ 1,784	2.10
Regular savings accounts and escrow	52,769	418	0.79	51,326	360	0.70	48,929	209	0.43
Checking and NOW accounts	52,682	288	0.55	39,857	46	0.12	37,620	49	0.13
Money market savings accounts	18,356	232	1.26	25,160	245	0.97	27,547	261	0.95
Total interest-bearing deposits	266,814	6,551	2.46	215,830	3,423	1.59	198,986	2,303	1.16
FHLB advances	59,423	2,789	4.69	38,530	1,512	3.92	27,379	1,256	4.59
Other borrowings	193	10	5.17	161	6	3.73	16	—	—
Total interest-bearing liabilities	326,431	9,350	2.86	254,521	4,941	1.94	226,381	3,559	1.57
Noninterest-bearing liabilities	1,639			1,869			1,767		
Total liabilities	328,070			256,390			228,148		
Stockholders' equity	51,868			52,024			29,279		
Total liabilities and stockholders' equity	\$379,938			\$308,414			\$257,427		
Net interest income		\$11,400			\$10,967			\$ 9,154	
Interest rate spread			3.07%			3.68%			3.78%
Net interest margin			3.26%			3.87%			3.85%
Average interest-earning assets to average interest-bearing liabilities			107.18%			111.20%			105.00%

Rate/Volume Analysis. The following table sets forth the effects of changing rates and volumes on our net interest income. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume. The net column represents the sum of the prior columns.

	2006 Compared to 2005			2005 Compared to 2004		
	Increase (Decrease)			Increase (Decrease)		
	Due to			Due to		
	Volume	Rate	Net	Volume	Rate	Net
	(In thousands)					
Interest income:						
Loans	\$3,254	\$ 610	\$3,864	\$2,114	\$ 288	\$2,402
Fed Funds sold	(8)	29	21	340	(458)	(118)
Investment securities	605	269	874	775	82	857
Federal Home Loan Bank stock	55	28	83	17	37	54
Total interest income	3,906	936	4,842	3,246	(51)	3,195
Interest expense:						
Certificate accounts	1,469	1,372	2,841	341	647	988
Regular savings accounts	10	48	58	11	140	151
Checking and NOW accounts ..	19	223	242	3	(6)	(3)
Money market savings accounts	128	(141)	(13)	(24)	8	(16)
Total deposit expense	1,626	1,502	3,128	331	789	1,120
FHLB advances	938	339	1,277	397	(141)	256
Other borrowings	1	3	4	—	6	6
Total interest expense	2,565	1,844	4,409	728	654	1,382
Net interest income	<u>\$1,341</u>	<u>\$ (908)</u>	<u>\$ 433</u>	<u>\$2,518</u>	<u>\$ (705)</u>	<u>\$1,813</u>

Provision for Loan Losses.

2006 v. 2005. In 2006, a \$191,871 provision was made to the allowance for loan losses. This provision is due to the increasing size of the loan portfolio, specifically, the increase in commercial construction, commercial real estate and commercial business loan portfolios, as well as an increase in the mortgage loan portfolio. In addition, there was an increase in the loans which were classified requiring an increase to the reserve. In 2006, there was an increase in nonperforming loans and as a result there was a decrease in the ratio of the allowance to nonperforming loans and assets.

2005 v. 2004. In 2005, a \$32,000 provision was made to the allowance for loan losses. The provision in 2005 is due to the increasing size of the loan portfolio, in particular, the increasing size of our construction, multi-family and commercial real estate and commercial business loan portfolios. In addition, there was an increase in the allowance due to net recoveries. During 2005 there was a decrease in nonperforming loans and assets. As a result there was an increase in the ratio of the allowance to nonperforming loans and assets.

Noninterest Income. The following table shows the components of noninterest income and the percentage changes from 2006 to 2005 and from 2005 to 2004.

	2006	2005	2004	% Change 2006/2005	% Change 2005/2004
	(Dollars in thousands)				
Fees for services related to deposit accounts	\$ 873	\$ 618	\$ 557	41.26%	10.95%
Fees for other services	540	356	315	51.69	13.02
Income from bank owned life insurance	304	218	201	39.45	8.46
Income from investment advisory services, net	98	167	93	(41.32)	79.57
Gain (loss) on sale of investments	6	47	(156)	(87.23)	130.13
Gain on sale of mortgages	—	—	5	N/A	(100.00)
Other income	127	111	63	14.41	76.19
Total	<u>\$1,948</u>	<u>\$1,517</u>	<u>\$1,078</u>	<u>28.41%</u>	<u>40.72%</u>

2006 v. 2005. Income from fees for services related to deposit accounts increased \$255,000, or 41.3% to \$873,000 for the year ended December 31, 2006 compared to \$618,000 for the year ended December 31, 2005 and income from fees for other services increased \$184,000 or 51.7% over the same period due to increased volume in these areas including that from new products and services. An increase of 39.4% or \$86,000 in income earned from investments in bank-owned life insurance was also recorded in the 2006 period. Income from investment advisory services decreased \$69,000, or 41.3% to \$98,000 for the year ended December 31, 2006 due to decreased volume in this area. The 2006 period included a \$6,000 gain on the sale of investments, while the 2005 period included a gain of \$47,000.

2005 v. 2004. Income from investment advisory services increased \$74,000, or 79.6%, to \$167,000 for the year ended December 31, 2005 compared to \$93,000 for the year ended December 31, 2004 due to increased volume in this area. Fees for services increased by \$102,000 or 11.7% to \$974,000 for the year ended December 31, 2005 up from \$872,000 for the year ended December 31, 2004. The 2004 period included a net loss on sale of investments of \$156,000, while the 2005 period included a gain of \$47,000. An increase of \$17,000, or 8.5%, in income earned from investments in bank-owned life insurance was also recorded in the 2005 period.

Noninterest Expense. The following table shows the components of noninterest expense and the percentage changes from 2006 to 2005 and from 2005 to 2004.

	2006	2005	2004	% Change 2006/2005	% Change 2005/2004
	(Dollars in thousands)				
Compensation, taxes and benefits	\$6,408	\$5,477	\$4,301	17.05%	27.34%
Office occupancy	1,757	1,538	1,191	14.24	29.14
Advertising	672	523	318	28.49	64.47
Computer processing	606	624	547	(2.88)	14.08
Directors compensation	516	435	335	17.93	29.85
Professional fees	380	448	272	(15.18)	64.71
Office supplies	193	232	190	(16.81)	22.11
Charitable contributions	34	34	1,587	(0.00)	(97.86)
Loss (gain) on foreclosed real estate, net	16	(35)	(57)	145.71	(38.60)
Prepayment fee on Federal Home Loan Bank advances	—	—	498	N/A	(100.00)
Other expenses	922	821	621	12.30	32.21
Total	<u>\$11,504</u>	<u>\$10,097</u>	<u>\$9,803</u>	<u>13.93%</u>	<u>3.00%</u>

Other expenses for all periods include, among other items, insurance, postage and expenses related to checking accounts.

2006 v. 2005. Noninterest expense increased primarily due to increases in compensation costs, office occupancy and advertising expenditures in the 2006 period. Compensation costs for employees increased by \$931,000, or 17.0% and compensation costs related to directors increased by \$81,000, or 18.6%. Employee related compensation includes new employees hired to staff our three new branch offices opened in 2006. The increase in director related compensation includes costs associated with a change from a retirement plan to a deferred compensation plan. In both expense categories, the 2006 period includes a full year of expenses related to the awards made under the equity incentive plan, while the 2005 period included only five months of these expenses. The increases in office occupancy and advertising expenses can be attributed to the opening of three new branch offices in 2006. These increases were partially offset by nominal decreases in professional fees, office supplies and computer processing.

2005 v. 2004 The increase in noninterest expense increase was primarily due to an increase of \$1.3 million in compensation costs, an increase of \$347,000 in office occupancy expenses, an increase of \$205,000 in advertising expenditures, an increase of \$176,000 in legal, accounting and consulting fees and an increase of \$77,000 in computer processing costs. The increase in advertising expense relates to more aggressive advertising for deposit products, while the increase in legal, accounting and consulting fees are the result of being a public company. The compensation costs in the 2005 period include expenses related to the adoption of the equity incentive plan previously approved by shareholders. Occupancy expenses increased in 2005 as a result of the opening of new branches in January and July 2005. The 2004 period included a charitable contribution of \$1.5 million to establish the Naugatuck Valley Savings and Loan Foundation and a prepayment charge of \$498,000 on the early payoff of \$9.6 million of FHLB borrowings.

Income Taxes

2006 v. 2005. Income taxes decreased due to a lower level of taxable income in the 2006 period. The Company continues to benefit from income exempt from income taxes including income from bank-owned life insurance, municipal securities and a portion of the income earned on preferred money market securities, along with deferred tax benefits related to tax bad debt reserves in the calculation of the effective tax rate. The effective tax rate for 2006 was 12.3% compared to 19.1% for 2005.

2005 v. 2004. Income taxes increased due to a higher level of taxable income in the 2005 period. The 2004 period included the charitable contribution resulting from the formation and funding of the Naugatuck Valley Savings and Loan Foundation. The Company continues to benefit from income exempt from income taxes including income from bank-owned life insurance and municipal securities, along with deferred tax benefits related to tax bad debt reserves in the calculation of the effective tax rate. The effective tax rate for 2005 was 19.1% compared to 3.3% for 2004.

Market Risk Analysis

Qualitative Aspects of Market Risk. Our most significant form of market risk is interest rate risk. We manage the interest rate sensitivity of our interest-bearing liabilities and interest-earning assets in an effort to minimize the adverse effects of changes in the interest rate environment. Deposit accounts typically react more quickly to changes in market interest rates than mortgage loans because of the shorter maturities of deposits. As a result, sharp increases in interest rates may adversely affect our earnings while decreases in interest rates may beneficially affect our earnings. To reduce the potential volatility of our earnings, we have sought to improve the match between assets and liability maturities (or rate adjustment periods), while maintaining an acceptable interest rate spread, by originating adjustable-rate mortgage loans for retention in our loan portfolio, variable-rate home equity lines and variable-rate commercial loans and by purchasing variable-rate investments and investments with expected maturities of less than 10 years. In 2002-2004 we sold a small percentage of our originations of longer term fixed-rate one- to four-family mortgage loans in the secondary market based on prevailing market interest rate conditions, an analysis of the composition and risk of the loan portfolio, liquidity needs and interest rate risk management goals. We did not sell any loans in 2005 or 2006. Generally, loans are sold without recourse and with servicing retained. We currently do not participate in hedging programs, interest rate swaps or other activities involving the use of off-balance sheet derivative financial instruments.

Our Asset/Liability Committee communicates, coordinates and controls all aspects of asset/liability management. The committee establishes and monitors the volume and mix of assets and funding sources with the objective of managing assets and funding sources.

Quantitative Aspects of Market Risk. We use an interest rate sensitivity analysis prepared by the Office of Thrift Supervision to review our level of interest rate risk. This analysis measures interest rate risk by computing changes in net portfolio value of our cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. Net portfolio value represents the market value of portfolio equity and is equal to the market value of assets minus the market value of liabilities, with adjustments made for off-balance sheet items. This analysis assesses the risk of loss in market risk sensitive instruments in the event of a sudden and sustained a 100 to 300 basis point increase or a 100 to 200 basis point decrease in market interest rates with no effect given to any steps that we might take to counter the effect of that interest rate movement. We measure interest rate risk by modeling the changes in net portfolio value over a variety of interest rate scenarios. The following table, which is based on information that we provide to the Office of Thrift Supervision, presents the change in our net portfolio value at December 31, 2006 that would occur in the event of an immediate change in interest rates based on Office of Thrift Supervision assumptions, with no effect given to any steps that we might take to counteract that change.

Basis Point ("bp") Change in Rates	Net Portfolio Value			Net Portfolio Value as % of Present Value of Assets	
	\$ Amount	\$ Change	% Change	NPV Ratio	Change
(Dollars in thousands)					
300 bp	\$29,864	\$(21,889)	(42)%	7.61%	(4.72)%
200	37,503	(14,250)	(28)	9.34	(2.99)
100	45,004	(6,749)	(13)	10.95	(1.38)
0	51,753	—	—	12.33	—
(100)	56,260	4,507	9	13.20	.87
(200)	57,498	5,744	11	13.38	1.05

The Office of Thrift Supervision uses certain assumptions in assessing the interest rate risk of savings associations. These assumptions relate to interest rates, loan prepayment rates, deposit decay rates, and the market values of certain assets under differing interest rate scenarios, among others. As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, expected rates of prepayments on loans and early withdrawals from certificates could deviate significantly from those assumed in calculating the table.

Liquidity and Capital Resources

Liquidity is the ability to meet current and future short-term financial obligations. Our primary sources of funds consist of deposit inflows, loan repayments, maturities and sales of investment securities, and advances from the Federal Home Loan Bank of Boston. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

Each quarter we project liquidity availability and demands on this liquidity for the next 90 days. We regularly adjust our investments in liquid assets based upon our assessment of (1) expected loan demand, (2) expected deposit flows, (3) yields available on interest-earning deposits and securities, and (4) the objectives of our asset/liability management program. Excess liquid assets are invested generally in Federal funds and short- and intermediate-term U.S. Government agency obligations.

Our most liquid assets are cash and cash equivalents and interest-bearing deposits. The levels of these assets depend on our operating, financing, lending and investing activities during any given period. At December

31, 2006, December 31, 2005 and December 31, 2004, cash and cash equivalents totaled \$7.9 million, \$9.0 million and \$7.6 million, respectively, including Federal funds of \$31,000, \$29,000 and \$23,000, respectively. Securities classified as available for sale, which provide additional sources of liquidity, totaled \$67.7 million, \$58.0 million, and \$31.1 million at December 31, 2006, December 31, 2005 and December 31, 2004, respectively. At December 31, 2006, December 31, 2005 and December 31, 2004, we had the ability to borrow a total of \$128.7 million, \$112.3 million and \$95.9 million, respectively, from the Federal Home Loan Bank of Boston, of which \$68.4 million, \$57.1 million and \$15.8 million was outstanding, respectively. At December 31, 2006, December 31, 2005 and December 31, 2004, we had arranged overnight lines of credit of \$2.5 million with the Federal Home Loan Bank of Boston for all periods. We had no overnight advances outstanding with the Federal Home Loan Bank of Boston on these dates. In addition, at December 31, 2006, December 31, 2005 and December 31, 2004, we had ability to borrow \$3.5 million, \$2.5 million and \$2.0 million, respectively from a correspondent bank. There were no advances outstanding on this line at December 31, 2006 and \$1.9 million was outstanding on this line at December 31, 2005. There were no advances outstanding of this line at December 31, 2004.

At December 31, 2006, we had \$21.0 million in unused line availability on home equity lines of credit, \$6.4 million in unadvanced commercial lines, \$5.1 million in mortgage commitments, \$3.6 million in commercial mortgage loan commitments, \$21.7 million in unadvanced construction mortgage commitments, \$6.8 million in letters of credit, \$1.3 million in commercial business loan commitments and \$91,000 in overdraft line of credit availability. Certificates of deposit due within one year of December 31, 2006 totaled \$145.1 million, or 50.2% of total deposits. If these deposits do not remain with us, we will be required to seek other sources of funds, including other certificates of deposit and lines of credit. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before December 31, 2007. We believe, however, based on past experience, that a significant portion of our certificates of deposit will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

Historically, we have remained highly liquid, with our liquidity position increasing substantially over the past two fiscal years. We expect that all of our liquidity needs, including the contractual commitments set forth in the table below, the estimated costs of our branch expansion plans and increases in loan demand can be met by our currently available liquid assets and cash flows. If loan demand were to increase at a pace greater than expected, or any unforeseen demand or commitment were to occur, we would access our borrowing capacity with the Federal Home Loan Bank of Boston. We expect that our currently available liquid assets and our ability to borrow from the Federal Home Loan Bank of Boston would be sufficient to satisfy our liquidity needs without any material adverse effect on our liquidity. We are not aware of any trends and/or demands, commitments, events or uncertainties that could result in a material decrease in liquidity.

The following table presents certain of our contractual obligations at December 31, 2006.

<u>Contractual Obligations</u>	<u>Payments Due by Period</u>				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 years</u>	<u>3-5 years</u>	<u>More than 5 years</u>
	<u>(In thousands)</u>				
Long-term debt obligations.....	\$68,488	\$30,465	\$33,890	\$2,860	\$1,273
Operating lease obligations.....	<u>2,008</u>	<u>200</u>	<u>425</u>	<u>428</u>	<u>955</u>
Total.....	<u>\$70,496</u>	<u>\$30,665</u>	<u>\$34,315</u>	<u>\$3,288</u>	<u>\$2,228</u>

Our primary investing activities are the origination of loans and the purchase of securities. For the year ended December 31, 2006 we originated \$109.1 million of loans and purchased \$31.4 million of securities. In 2005, we originated \$124.2 million of loans and purchased \$51.1 million of securities. In 2004, we originated \$83.8 million of loans and purchased \$24.4 million of securities. During the year ended December 31, 2006, these activities were funded primarily by an increase in deposits of \$48.4 million, net advances from the Federal Home Loan Bank of Boston of \$11.4 million, proceeds from sales and maturities of available-for-sale securities of \$21.9 million and proceeds from held-to-maturity securities of \$2.5 million. During the year ended December 31, 2005, these activities were funded primarily by an increase in deposits of \$47.5 million, net advances from the Federal Home Loan Bank of Boston of \$41.2 million, proceeds from sales and maturities of available-for-sale securities of \$23.0 million and proceeds from held-to-maturity securities of \$665,000. During the year ended December 31, 2004, these activities were funded primarily by the net proceeds from the stock issuance of \$31.6 million, proceeds

from sales and maturities of available-for-sale securities of \$26.2 million, an increase of deposits of \$9.9 million and proceeds from the sale of loans of \$1.9 million.

Historically, our investment portfolio had been funded by excess liquidity when deposit inflows exceed loan demand. During 2006, we implemented a pre-purchase strategy with the objective of enhancing earnings by borrowing \$6.5 million from the Federal Home Loan Bank of Boston on a short-term basis to fund the purchase of a like amount of long-term securities. These advances were paid down by subsequent investment maturities. This strategy was accretive to earnings.

Financing activities consist primarily of activity in deposit accounts and in Federal Home Loan Bank advances. We experienced a net increase in total deposits of \$48.4 million, \$47.5 million and \$9.9 million for the years ended December 31, 2006, 2005 and 2004, respectively. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors and other factors. We generally manage the pricing of our deposits to be competitive and to increase core deposit relationships. Occasionally, we offer promotional rates on certain deposit products in order to attract deposits. We experienced an increase in Federal Home Loan Bank advances of \$11.4 million for the year ended December 31, 2006. The increase in 2006 was primarily due to lending and investing activities. Federal Home Loan Bank advances increased \$41.2 million for the year ended December 31, 2005, and decreased \$19.1 million for the year ended December 31, 2004. The increase in advances in 2005 was primarily used for our lending and investing activities. During 2004, \$9.6 million of advances with an average rate of 5.29% were prepaid in an effort to reduce the cost of funds.

We are subject to various regulatory capital requirements administered by the Office of Thrift Supervision, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At December 31, 2006, we exceeded all of our regulatory capital requirements. We are considered "well capitalized" under regulatory guidelines. See note 13 of the notes to the financial statements in this annual report.

Off-Balance Sheet Arrangements

In the normal course of operations, we engage in a variety of financial transactions that, in accordance with generally accepted accounting principles, are not recorded in our financial statements. These transactions involve, to varying degrees, elements of credit, interest rate, and liquidity risk. Such transactions are used primarily to manage customers' requests for funding and take the form of loan commitments, unused lines of credit, amounts due mortgagors on construction loans, amounts due on commercial loans, commercial letters of credit and commitments to sell loans. See note 15 of the notes to the financial statements in this annual report.

For the years ended December 31, 2006, 2005 and 2004, we engaged in no off-balance-sheet transactions reasonably likely to have a material effect on our financial condition, results of operations or cash flows.

Effect of Inflation and Changing Prices

We have prepared the financial statements and related financial data presented in this report in accordance with generally accepted accounting principles in the United States, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The primary impact of inflation on our operations is reflected in increased operating costs. Unlike most industrial companies, virtually all of our assets and liabilities are monetary in nature. As a result, interest rates generally have a more significant impact on our performance than do general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

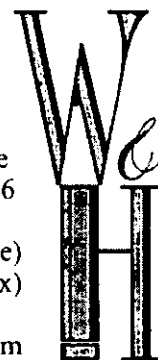
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Report of Independent Registered Public Accounting Firm

To The Board of Directors and Shareholders
Naugatuck Valley Financial Corporation

We have audited the accompanying consolidated statements of financial condition of Naugatuck Valley Financial Corporation (the "Company") and subsidiary as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the years ended December 31, 2006, 2005 and 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Companies Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Naugatuck Valley Financial Corporation and subsidiary at December 31, 2006 and 2005, and the results of its operations and its cash flows for the each of the years ended December 31, 2006, 2005 and 2004, in conformity with accounting principles generally accepted in the United States of America.

Whittlesey & Hadley, P.C.

Hartford, Connecticut
March 9, 2007



Consolidated Statements of Financial Condition

(Dollars in thousands)

	December 31,	
	2006	2005
ASSETS		
Cash and due from depository institutions	\$ 7,911	\$ 8,922
Investment in federal funds	31	29
Investment securities	70,267	63,049
Loans receivable, net	308,376	259,427
Accrued income receivable	1,904	1,525
Premises and equipment, net	11,209	9,087
Bank owned life insurance asset	7,956	7,652
Federal Home Loan Bank of Boston stock	3,898	3,159
Other assets	2,303	2,496
Total assets	\$ 413,855	\$ 355,346
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits	\$ 289,198	\$ 240,846
Advances from Federal Home Loan Bank of Boston	68,488	57,059
Mortgagors' escrow accounts	3,495	3,202
Other liabilities	1,590	3,275
Total liabilities	362,771	304,382
Commitments and contingencies		
Stockholders' Equity		
Common stock, \$.01 par value; 25,000,000 shares authorized; 7,604,375 shares issued; shares outstanding - 7,473,225 at December 31, 2006; 7,604,375 at December 31, 2005	76	76
Preferred stock, \$.01 par value; 1,000,000 shares authorized; no shares issued or outstanding	-	-
Paid-in capital	33,302	33,157
Retained earnings	23,415	22,588
Unearned ESOP shares (253,402 shares at December 31, 2006 and 273,291 shares at December 31, 2005)	(2,534)	(2,733)
Unearned stock awards (113,266 shares at December 31, 2006 and 139,712 shares at December 31, 2005)	(1,256)	(1,551)
Treasury Stock, at cost (138,983 shares at December 31, 2006 and 9,333 shares at December 31, 2005)	(1,593)	(122)
Accumulated other comprehensive loss	(326)	(451)
Total stockholders' equity	51,084	50,964
Total liabilities and stockholders' equity	\$ 413,855	\$ 355,346

See notes to consolidated financial statements.



Consolidated Statements of Income

(Dollars in thousands, except earnings per share)

	For the Years Ended December 31,		
	2006	2005	2004
Interest and dividend income			
Interest on loans	\$ 17,506	\$ 13,642	\$ 11,240
Interest and dividends on investments and deposits	3,244	2,266	1,473
Total interest income	20,750	15,908	12,713
Interest expense			
Interest on deposits	6,551	3,423	2,303
Interest on borrowed funds	2,799	1,518	1,256
Total interest expense	9,350	4,941	3,559
Net interest income	11,400	10,967	9,154
Provision for loan losses	192	32	-
Net interest income after provision for loan losses	11,208	10,935	9,154
Noninterest income			
Fees for services related to deposit accounts	873	618	557
Fees for other services	540	356	315
Income from bank owned life insurance	304	218	201
Income from investment advisory services, net	98	167	93
Gain (loss) on sale of investments	6	47	(156)
Gain on sale of mortgages	-	-	5
Other income	127	111	63
Total noninterest income	1,948	1,517	1,078
Noninterest expense			
Compensation, taxes and benefits	6,408	5,477	4,301
Office occupancy	1,757	1,538	1,191
Advertising	672	523	318
Computer processing	606	624	547
Directors compensation	516	435	335
Professional fees	380	448	272
Office supplies	193	232	190
Contributions	34	34	1,587
Loss (gain) on foreclosed real estate, net	16	(35)	(57)
Prepayment fee on Federal Home			
Loan Bank of Boston advances	-	-	498
Other expenses	922	821	621
Total noninterest expense	11,504	10,097	9,803
Income before provision for income taxes	1,652	2,355	429
Provision for income taxes	204	450	14
Net income	\$ 1,448	\$ 1,905	\$ 415
Earnings per share - basic and diluted	\$ 0.20	\$ 0.26	N/M

See notes to consolidated financial statements.



Consolidated Statements of Changes in Stockholders' Equity

(Dollars in thousands)

	Common Stock	Paid-in Capital
Balance at December 31, 2004	\$ 76	\$ 33,089
ESOP shares released - 19,889 shares	-	19
Dividends paid (\$0.16 per common share)	-	-
Stock acquired for future stock awards - 9,333 shares	-	-
Stock based compensation - 139,712 shares	-	49
Comprehensive income:		
Net income	-	-
Net change in unrealized holding gain on available-for-sale securities, net of tax effect		
Comprehensive income	-	-
Balance at December 31, 2005	76	33,157
ESOP shares released - 19,889 shares	-	22
Dividends paid (\$0.20 per common share)	-	-
Stock based compensation	-	123
Treasury stock acquired - 131,150 shares	-	-
Comprehensive income:		
Net income	-	-
Net change in unrealized holding gain on available-for-sale securities, net of tax effect		
Comprehensive income	-	-
Balance at December 31, 2006	\$ 76	\$ 33,302

See notes to consolidated financial statements.



Retained Earnings	Unearned ESOP Shares	Unearned Stock Awards	Treasury Stock	Accumulated Other Comprehensive Loss	Total
\$ 21,362	\$ (2,932)	\$ -	\$ -	\$ (24)	\$ 51,571
-	199	-	-	-	218
(500)	-	-	-	-	(500)
-	-	-	(122)	-	(122)
(179)	-	(1,551)	-	-	(1,681)
1,905	-	-	-	-	-
-	-	-	-	(427)	1,478
22,588	(2,733)	(1,551)	(122)	(451)	50,964
-	199	-	-	-	221
(617)	-	-	-	-	(617)
(4)	-	295	20	-	434
-	-	-	(1,491)	-	(1,491)
1,448	-	-	-	-	-
-	-	-	-	125	1,573
\$ 23,415	\$ (2,534)	(1,256)	\$ (1,593)	\$ (326)	\$ 51,084

See notes to consolidated financial statements.



Consolidated Statements of Cash Flows

(In thousands)

	For the Years Ended December 31,		
	2006	2005	2004
Cash flows from operating activities			
Net income	\$ 1,448	\$ 1,905	\$ 415
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	192	32	-
Contribution of common stock to charitable foundation	-	-	1,519
Depreciation and amortization expense	654	686	642
Provision for deferred tax (benefit)	(75)	(177)	(464)
Net gain on sale of real estate owned	(4)	(46)	(68)
Gain on sale of mortgages	-	-	(5)
Loans originated for sale	-	-	(1,930)
Proceeds from sale of loans	-	-	1,935
(Gain) loss on sale of investments	(6)	(47)	156
Loss on disposal of premises and equipment	1	14	-
Stock-based compensation	657	397	53
Increase in accrued income receivable	(379)	(448)	(5)
Increase (decrease) in deferred loan fees	9	(11)	73
Increase in cash surrender value of life insurance	(304)	(218)	(201)
Decrease (increase) in other assets	107	(319)	2
Increase (decrease) in other liabilities	228	(381)	(33)
Net cash provided by operating activities	<u>2,528</u>	<u>1,387</u>	<u>2,089</u>
Cash flows from investing activities			
Proceeds from maturities and repayments of available-for-sale securities	16,779	19,245	9,222
Proceeds from sale of available-for-sale securities	5,163	3,742	16,982
Proceeds from maturities of held-to-maturity securities	2,470	665	-
Purchase of available-for-sale securities	(31,401)	(50,593)	(20,830)
Purchase of held-to-maturity securities	-	(500)	(3,610)
Loan originations net of principal payments	(49,148)	(55,674)	(23,582)
Purchase of Federal Home Loan Bank of Boston stock	(739)	(980)	(423)
Proceeds from the sale of foreclosed real estate	50	113	277
Proceeds from sale of property and equipment	2	11	-
Purchase of property and equipment	(2,780)	(1,943)	(2,157)
Purchase of bank owned life insurance asset	-	(2,500)	-
Net cash used by investing activities	<u>(59,604)</u>	<u>(88,414)</u>	<u>(24,121)</u>

See notes to consolidated financial statements.



	For the Years Ended December 31,		
	2006	2005	2004
Cash flows from financing activities			
Net change in time deposits	42,645	41,231	(4,992)
Net change in other deposit accounts	5,707	6,249	14,903
Advances from Federal Home Loan Bank of Boston	51,250	62,193	19,650
Repayment of Advances from Federal Home Loan Bank of Boston	(39,821)	(20,960)	(38,814)
Net change in mortgagors' escrow accounts	293	143	424
Change in short-term borrowings	(1,899)	1,899	-
Common stock repurchased	(1,491)	(1,852)	-
Cash dividends to common stockholders	(617)	(500)	-
Proceeds from issuance of common stock	-	-	32,601
Cost of issuance of common stock	-	-	(959)
Payments to acquire common stock for ESOP	-	-	(2,981)
Net cash provided by financing activities	<u>56,067</u>	<u>88,403</u>	<u>19,832</u>
(Decrease) Increase in cash and cash equivalents	(1,009)	1,376	(2,200)
Cash and cash equivalents at beginning of year	<u>8,951</u>	<u>7,575</u>	<u>9,775</u>
Cash and cash equivalents at end of year	\$ 7,942	\$ 8,951	\$ 7,575

Supplemental disclosures

Non-cash investing activities:

Transfer of loans to foreclosed real estate	\$ -	\$ 47	\$ 67
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Cash paid during the year for:

Interest	\$ 9,347	\$ 4,939	\$ 3,562
Income taxes	305	683	454

See notes to consolidated financial statements.



Notes to Consolidated Financial Statements

1. Nature of Operations

Naugatuck Valley Financial Corporation (the "Company") is a federally chartered holding company formed on September 30, 2004 for the purpose of acquiring all of the common stock of the Naugatuck Valley Savings and Loan (the "Bank") concurrent with its reorganization from a mutual savings institution to the mutual holding company form of organization. The reorganization was consummated on September 30, 2004. In connection with the reorganization, the Company sold 3,269,881 shares of its common stock, par value \$.01 per share, in a subscription offering and issued 4,182,407 shares to Naugatuck Valley Mutual Holding Company, raising approximately \$31.7 million, net of costs. Approximately \$15.9 million of the proceeds were contributed to the Bank. The Company is a majority owned subsidiary of Naugatuck Valley Mutual Holding Company, a federally chartered mutual holding company.

In addition, at the time of the reorganization, the Company contributed 152,087 shares of its stock to the Naugatuck Valley Savings and Loan Foundation. The foundation is a 501(c)(3) organization formed by the Company to support charitable activities within its community.

Originally organized in 1922, the Bank is a federally chartered stock savings bank which is headquartered in Naugatuck, Connecticut. The Bank provides a full range of personal banking services to individual and small business customers located primarily in the Naugatuck Valley and the immediate surrounding vicinity. It is subject to competition from other financial institutions throughout the region. The Bank is also subject to the regulations of various federal agencies and undergoes periodic examinations by those regulatory authorities.

The Bank owns the Naugatuck Valley Mortgage Servicing Corporation, which qualifies and operates as a Connecticut passive investment company pursuant to legislation.

2. Summary of Significant Accounting Policies

The accounting and reporting policies of the Company and its subsidiary conform to generally accepted accounting principles in the United States of America and to general practices within the thrift industry. Such policies have been followed on a consistent basis. The significant accounting policies of the Company are summarized below.

Use of estimates

In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet, and income and expenses for the period. Actual results could differ from those estimates.

Material estimates that are particularly

susceptible to significant change in the near-term relate to the determination of the allowance for losses on loans and the valuation of real estate acquired in connection with foreclosure or in satisfaction of loans. While management uses available information to recognize losses on loans and foreclosed real estate, future additions to the allowance may be necessary based on



Notes to Consolidated Financial Statements

changes in economic conditions, particularly in Connecticut.

Principles of consolidation

The consolidated financial statements include the accounts of the Company, the Bank and the Bank's wholly-owned subsidiary, Naugatuck Valley Mortgage Servicing Corporation. All significant intercompany accounts and transactions have been eliminated in consolidation.

Investment securities

Investments are accounted for in accordance with the intent of management at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold debt securities until maturity, they are classified as held-to-maturity. These securities are carried at historical cost adjusted for the amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income.

Securities to be held for indefinite periods of time are classified as available-for-sale and are carried at fair value with unrealized gains and losses reported as a separate component of capital net of estimated income taxes.

The Company has no securities held for trading.

Gains or losses on the sales of securities are recognized at trade date utilizing the specific identification method.

Loans receivable and allowance for loan losses

Loans receivable are stated at unpaid principal balance undistributed construction loans, deferred loan fees, and allowances for loan losses.

Uncollected interest on loans receivable is accrued as earned based on rates applied to

principal amounts outstanding. Recognition of income on the accrual basis is discontinued when there is sufficient question as to the collectibility of the interest. In these cases, the interest previously accrued to income is reversed, and the loans are placed on the cash basis.

Loan origination fees and certain direct loan origination costs are being deferred and the net amount amortized on a level-yield basis as an adjustment to the related loan yield over its contractual life. Unamortized net fees are recognized upon early repayment of the loans.

The allowance for loan losses is established by a provision charged to earnings and is maintained at a level considered adequate to provide for potential loan losses based on management's evaluation of known and inherent risks in the loan portfolio. When a loan or portion of a loan is considered uncollectible, it is charged against the allowance for loan losses. Recoveries of loans previously charged-off are credited to the allowance when collected.

Management makes regular evaluations of the loan portfolio to determine the adequacy of the level of the allowance for loan losses. Numerous factors are considered in the evaluation, including a review of certain borrowers' current financial status and credit standing, available collateral, loss experience in relation to outstanding loans, the overall loan portfolio quality, management's judgment regarding prevailing and anticipated economic conditions, and other relevant factors.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.



Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies -- (Continued)

Loan sales and mortgage-servicing rights

Residential mortgage loans originated and held for sale are classified separately in the consolidated statement of financial condition and reported at the lower of amortized cost or market value (based on secondary market prices). There were no loans held for sale at December 31, 2006 and 2005. Gains or losses on the sale of loans are determined using the specific identification method.

The Bank sells residential mortgage loans with servicing rights retained. At the time of the sale, the Bank determines the value of the retained servicing rights, which represents the present value of the differential between the contractual servicing fee and adequate compensation, defined as the fee a sub-servicer would require to assume the role of servicer, after considering the estimated effects of prepayments. If material, a portion of the gain on the sale of the loan is recognized as due to the value of the servicing rights, and a servicing asset is recorded. The Bank has had no loan sales which have resulted in the recording of a servicing asset, due to the immaterial differential between the contractual servicing fee (25 basis points) and adequate compensation, as described above.

Foreclosed real estate

Real estate properties acquired through loan foreclosure and other partial or total satisfaction of problem loans are carried at the lower of fair value or the related loan balance at the date of foreclosure.

Valuations are periodically performed by management and an allowance for losses is established if the carrying value of a property subsequently exceeds its fair value less

estimated disposal costs. Losses arising at the time of acquisition of such properties are charged against the allowance for loan losses. Subsequent write-downs in the carrying value and expenses incurred to maintain the properties are charged to expense.

Premises and equipment

Premises and equipment are stated at cost less accumulated depreciation computed on the straight-line method at rates based on estimated useful lives.

Expenditures for replacements or major improvements are capitalized. Expenditures for normal maintenance and repairs are charged to expense as incurred. Upon the sale or retirement of premises and equipment, the cost and accumulated depreciation are removed from their respective accounts and any gain or loss is included in income.

Bank owned life insurance asset

The cash surrender value of bank owned life insurance relates to policies on employees of the Bank for which the Bank is the beneficiary. Increases in cash surrender value are included in non-interest income in the consolidated income statements.

Income from investment advisory services, net

In conjunction with a third party, an employee of the Bank is licensed to sell non-deposit investment products, including mutual funds, annuities and other insurance products. The Bank records, as noninterest income, revenues earned from product sales in accordance with the terms of revenue sharing agreements with the third party, net of certain marketing and other



Notes to Consolidated Financial Statements

expenses shared with the third party. The Bank currently employs the individual authorized to sell these products and pays most of the direct costs related to the sales activities. These costs are charged to expense as incurred, and are classified primarily in compensation and benefits expense.

Income taxes

The Company accounts for certain income and expense items differently for financial reporting purposes than for income tax purposes. Provisions for deferred taxes are being made in recognition of these temporary differences.

Earnings per share

When presented, basic earnings per share is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Because the formation of the Company was completed on September 30, 2004, per share earnings data is not meaningful for 2004.

Computation of fair values

The calculation of fair value estimates of financial instruments is dependent upon certain subjective assumptions and involves significant uncertainties. Changes in assumptions could significantly affect the estimates. These estimates do not reflect any possible tax ramifications, estimated transaction costs or any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument.

The following methods and assumptions were utilized by the Company in estimating the fair values of its on-balance sheet financial instruments:

Cash and cash equivalents - The carrying amounts reported in the statement of financial condition approximate these assets' fair value.

Investment securities - Fair values for investment securities are based on quoted market prices where available. If quoted market prices are not available, fair values are based on market prices for comparable instruments.

Loans receivable - For variable rate loans that reprice frequently and without significant change in credit risk, fair values are based on carrying values. The fair value of other loans are estimated using discounted cash flow analyses using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The fair value of nonaccrual loans was estimated using the estimated fair values of the underlying collateral.

Deposits liabilities - The fair values of non-interest-bearing demand and savings deposits are, by definition, equal to the amount payable on demand at the reporting date, i.e., their carrying amounts. Fair values for time certificates of deposit are estimated using a discounted cash flow technique that applies interest rates currently being offered to a schedule of aggregated expected monthly maturities on time deposits.

Advances from Federal Home Loan Bank of Boston ("FHLBB") - Fair values are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Mortgagors' escrow accounts - The carrying amounts reported in the statement of financial condition approximate the fair value of the mortgagors' escrow accounts.



Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies – (Continued)

Recent Accounting Pronouncements

In September, 2006 the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which includes amendments to Statements 87, 106, and 132 (R). The Statement requires a company to fully recognize, as an asset or liability, the over-funded or under-funded status of its benefit plan in its 2006 year-end balance sheet. This will result in the immediate recognition (on the balance sheet) of amounts that would have been recognized in subsequent years (off-balance sheet). Unrecognized prior service costs and credits, any unrecognized net actuarial gains or losses and transition obligations and assets will be recorded as components of other comprehensive income ("OCI"). In subsequent periods, these amounts will be reclassified from OCI and recognized in income as components of net periodic benefit cost pursuant to Statements 87, 88 and 106. Statement 158 will not change how these amounts are recognized in the income statement. Implementation of the new standard had no effect on the financial statements, because the Company participates in a multi-employer plan. The accounting and disclosure requirements for multiemployer plans were unchanged by the new standard.

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Tax Positions." This Interpretation clarifies the application of SFAS No. 109, "Accounting for Income Taxes," by establishing a threshold condition that a tax position must meet for any part of the benefit of

that position to be recognized in the financial statements. In addition to recognition, FASB Interpretation No. 48 provides guidance concerning measurement, derecognition, classification, and disclosure of tax positions and is effective for fiscal years beginning after December 15, 2006. Adoption of this Interpretation is not expected to have a significant impact on the results of operations and financial condition.

In March 2006, the Financial Accounting Standards Board issued Statement No. 156, "Accounting for Servicing of Financial Assets." Statement 156, which is an amendment to SFAS No. 140, simplifies the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. The new Standard clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability; requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; and permits an entity with a separately recognized servicing asset or servicing liability to choose either the Amortization Method or Fair Value Method for subsequent measurement. Statement No. 156 is effective for separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity's fiscal year that begins after September 15, 2006, with early adoption permitted. Adoption of this statement is not expected to have a material effect on results of operations or financial condition.

Reclassification

The financial statements for the prior years have been reclassified to conform with changes in the current financial statement presentation.



Notes to Consolidated Financial Statements

3. Investment Securities

A summary of investment securities at December 31, 2006 and 2005 follows:

	2006		2005	
<i>(In thousands)</i>	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Available-for-sale securities	\$ 67,736	\$ 67,736	\$ 58,047	\$ 58,047
Held-to-maturity securities	2,531	2,522	5,002	4,989
Total investment securities	\$ 70,267	\$ 70,258	\$ 63,049	\$ 63,036

At December 31, 2006, the composition of the investment portfolio was:

<i>(In thousands)</i>	Amortized Cost Basis	Gross Unrealized		Fair Value
		Gains	Losses	
Available-for-sale securities:				
U.S. government and agency obligations				
Less than one year	\$ 4,000	\$ -	\$ (37)	\$ 3,963
From one through five years	3,495	-	(23)	3,472
From five through ten years	1,000	-	(20)	980
	8,495	-	(80)	8,415
Municipal obligations				
Less than one year	1,000	-	(1)	999
From five through ten years	828	2	-	830
After ten years	13,349	49	(37)	13,361
	15,177	51	(38)	15,190
Corporate bonds				
From one through five years	1,951	8	(4)	1,955
Mortgage-backed securities	25,111	60	(389)	24,782
Collateralized mortgage obligations	4,796	6	(108)	4,694
Total debt securities	55,530	125	(619)	55,036
Money market preferred stocks	12,700	-	-	12,700
Total available-for-sale securities	\$ 68,230	\$ 125	\$ (619)	\$ 67,736



Notes to Consolidated Financial Statements

3. Investment Securities – (Continued)

	Amortized	Gross Unrealized		Fair
(In thousands)	Cost Basis	Gains	Losses	Value
Held-to-maturity securities:				
U.S. government and agency obligations				
From one through five years	\$ 1,201	\$ -	\$ (9)	\$ 1,192
Interest bearing balances				
Less than one year	1,140	-	-	1,140
From one through five years	190	-	-	190
Total held-to-maturity securities	\$ 2,531	\$ -	\$ (9)	\$ 2,522

At December 31, 2005, the composition of the investment portfolio was:

(In thousands)	Amortized Cost Basis	Gross Unrealized		Fair Value
		Gains	Losses	
Available-for-sale securities:				
U.S. government and agency obligations				
Less than one year	\$ 6,847	\$ 8	\$ (49)	\$ 6,806
From one through five years	7,497	2	(95)	7,404
From five through ten years	<u>1,000</u>	<u>-</u>	<u>(35)</u>	<u>965</u>
	15,344	10	(179)	15,175
Municipal obligations				
After ten years	8,715	61	(7)	8,769
Corporate bonds				
From one through five years	1,928	-	(5)	1,923
Mortgage-backed securities	22,544	1	(463)	22,082
Collateralized mortgage obligations	<u>4,199</u>	<u>-</u>	<u>(101)</u>	<u>4,098</u>
Total debt securities	52,730	72	(755)	52,047
Money market preferred stocks	<u>6,000</u>	<u>-</u>	<u>-</u>	<u>6,000</u>
Total available-for-sale securities	<u>\$ 58,730</u>	<u>\$ 72</u>	<u>\$ (755)</u>	<u>\$ 58,047</u>
Held-to-maturity securities:				
U.S. government and agency obligations				
From one through five years	\$ 1,202	\$ 1	\$ (14)	\$ 1,189
Interest bearing balances				
From one through five years	<u>3,800</u>	<u>-</u>	<u>-</u>	<u>3,800</u>
Total held-to-maturity securities	<u>\$ 5,002</u>	<u>\$ 1</u>	<u>\$ (14)</u>	<u>\$ 4,989</u>



Notes to Consolidated Financial Statements

The Company has certain investment securities in which the market value of the security is less than the cost of the security. Management believes that these unrealized losses are temporary and are the result of changes in market interest rates. In making this determination, management considered the period of time the securities have been in a loss position, the percentage decline in comparison to the securities' amortized cost, the financial condition of the issuer and the Company's ability and intent to hold these securities until their fair value recovers to their amortized cost. At December 31, 2006, these securities had an aggregate fair value of \$38,170,000 which resulted in unrealized losses of \$628,000.

The following is a summary of the fair value and related unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2006.

	Securities in Continuous Unrealized Loss Position Less Than 12 Months		
	Number of Securities	Market Value	Unrealized Loss
<i>(Dollars in thousands)</i>			
U.S. government and agency obligations	3	\$ 999	\$ (1)
Municipal obligations	9	5,615	(38)
Corporate bonds	1	492	(2)
Total securities in unrealized loss position	13	\$ 7,106	\$ (41)

	Securities in Continuous Unrealized Loss Position 12 or More Consecutive Months		
	Number of Securities	Market Value	Unrealized Loss
<i>(Dollars in thousands)</i>			
U.S. government and agency obligations	15	\$ 8,606	\$ (88)
Mortgage-backed securities	24	21,486	(497)
Corporate bonds	1	972	(2)
Total securities in unrealized loss position	40	\$ 31,064	\$ (587)

For the year ended December 31, 2006, the Company realized gross gains of \$20,224 and gross losses of \$14,436 compared with realized gross gains of \$47,046 and no gross losses for the year ended December 31, 2005 and realized gross gains of \$23,787 and gross losses of \$179,952 for the year ended December 31, 2004 on sales of investment securities.

At December 31, 2006 and 2005, securities with a carrying value of \$3,200,000 and \$1,200,000, and fair values of approximately \$3,173,000 and \$1,188,000, respectively, were pledged as collateral to secure municipal deposits.



Notes to Consolidated Financial Statements

4. Loans Receivable

A summary of loans receivable at December 31, 2006 and 2005 is as follows:

<i>(Dollars in thousands)</i>	2006	2005
Loans secured by first mortgages on real estate:		
Conventional:		
Fixed rate mortgage loans	\$ 148,357	\$ 127,924
Adjustable rate mortgage loans	29,364	28,245
Construction loans	6,960	6,063
Commercial loans	84,203	62,946
Loans on savings accounts	634	785
Personal, auto and property improvement loans	43,682	38,001
	<u>313,200</u>	<u>263,964</u>
Less: Allowance for loan losses	2,071	1,878
Undisbursed construction loans	2,343	2,258
Deferred loan origination fees	410	401
	<u>4,824</u>	<u>4,537</u>
Loans receivable, net	\$ 308,376	\$ 259,427
Weighted average yield	6.32%	6.07%

The Bank's lending activities are conducted principally in the Naugatuck Valley area of Connecticut. The Bank's investment in loans includes both adjustable and fixed rate loans. At December 31, 2006 and 2005, the composition of the Bank's investment in fixed rate loans was as follows:

	Fixed Rate	
Term to Maturity	2006	2005
<i>(In thousands)</i>		
Less than 1 year	\$ 6,660	\$ 5,907
1 - 3 years	3,155	1,683
3 - 5 years	2,581	1,970
5 - 10 years	21,985	19,222
10 - 20 years	54,486	52,887
Over 20 years	99,089	73,970
Total loans at fixed rates	\$ 187,956	\$ 155,639



Notes to Consolidated Financial Statements

Adjustable rate loans have interest rate adjustment limitations and are indexed to treasury notes or FHLBB classic advances with similar repricing durations, or prime rate. At December 31, 2006 and 2005, the Bank had the following adjustable rate loans:

Adjustable Rate			
Rate Adjustment	2006	2005	
<i>(In thousands)</i>			
Less than 1 year	\$ 53,248	\$ 53,453	
1 - 3 years	13,388	15,792	
3 - 5 years	37,109	21,230	
5 - 10 years	20,736	16,990	
Over 10 years	763	860	
Total loans at adjustable rates	\$ 125,244	\$ 108,325	

Nonperforming loans totaled approximately \$2.0 million and \$294,000 at December 31, 2006 and 2005, respectively. These loans, primarily delinquent 90 days or more, were accounted for on a nonaccrual basis. The amount of income that was contractually due but not recognized on nonperforming loans totaled \$68,200, \$20,900, and \$44,600 in 2006, 2005 and 2004, respectively.

At December 31, 2006 the Bank had approximately \$49,500 of loans with an allowance of \$2,000 which were considered to be impaired. These loans averaged \$51,000 during 2006 and paid \$2,400 in interest. There were no loans considered to be impaired by the Bank at December 31, 2005.

Transactions in the allowance for loan losses account for the years ended December 31, 2006, 2005 and 2004 were as follows:

<i>(In thousands)</i>	2006	2005	2004
Balance at beginning of year	\$ 1,878	\$ 1,829	\$ 1,810
Provision for loan losses	192	32	-
Loans written off	(2)	(4)	(56)
Recoveries of loans written off	3	21	75
Balance at end of year	\$ 2,071	\$ 1,878	\$ 1,829

As of December 31, 2006 and 2005, loans to related parties totaled approximately \$3,711,000 and \$3,269,000, respectively. For the year ended December 31, 2006, new loans of approximately \$538,000 were granted to these parties and principal payments of approximately \$180,000 were received. During 2006, an additional \$84,000 in existing loans were included in loans to related parties for an individual who became a related party during the year. For the year ended December 31, 2005, new loans of approximately \$375,000 were granted to these parties and principal payments of approximately \$586,000



Notes to Consolidated Financial Statements

4. Loans Receivable – (Continued)

were received. Related parties include directors and officers of the Bank, any respective affiliates in which they have a controlling interest, and their immediate families. For the years ended December 31, 2006 and 2005, all loans to related parties were performing in accordance with the original terms.

The Bank services loans for other financial institutions and agencies. These loans are originated by the Bank and then sold. The Bank continues to service these loans and remits the payments received to the purchasing institution. The amounts of these loans were approximately \$10,121,000 and \$10,632,000 at December 31, 2006 and 2005, respectively.

5. Premises and Equipment

Premises and equipment at December 31, 2006 and 2005 are summarized as follows:

<i>(In thousands)</i>	2006	2005
Banking offices and branch buildings	\$ 8,489	\$ 6,819
Furniture and equipment	3,241	2,535
Land	1,551	1,538
Leasehold improvements	1,227	1,067
	<u>14,508</u>	<u>11,959</u>
Accumulated depreciation and amortization	<u>(3,299)</u>	<u>(2,872)</u>
Premises and equipment, net	\$ 11,209	\$ 9,087

Depreciation and amortization expense is computed using the straight-line method over the estimated useful life of an asset. Estimated useful lives range from three to ten years for furniture and equipment, 39 years for the banking offices, and the initial lease term for leasehold improvements. Land is not depreciated. Depreciation and amortization expenses were \$655,607 and \$596,670 and \$511,159 for the years ended December 31, 2006, 2005 and 2004, respectively.

At December 31, 2006, future minimum rental income and lease payment expense were expected to be:

<i>(In thousands)</i>	Income	Expense
2007	\$ 98	\$ 200
2008	98	208
2009	100	217
2010	102	233
2011	98	195
Thereafter	<u>139</u>	<u>955</u>
Total future minimum rents	\$ 635	\$ 2,008



Notes to Consolidated Financial Statements

6. Deposits

Deposits and weighted average rates at December 31, 2006 and 2005 are summarized as follows:

<i>(Dollars in thousands)</i>	2006		2005	
	Amount	Weighted Average Cost	Amount	Weighted Average Cost
Certificate accounts	\$ 165,076	4.43%	\$ 122,431	3.38%
Regular savings accounts	46,156	0.63%	51,375	0.85%
Checking and NOW accounts	57,301	0.73%	46,825	0.10%
Money market savings accounts	20,665	1.89%	20,215	0.88%
Total deposits	\$ 289,198	2.91%	\$ 240,846	1.99%

The aggregate amount of individual certificate accounts of \$100,000 or more at December 31, 2006 and 2005 was \$48,228,000 and \$32,001,000 respectively. Deposits up to \$100,000 are federally insured. In addition, federal law provides up to \$250,000 in deposit insurance coverage for self-directed retirement accounts, such as Individual Retirement Accounts (IRAs).

At December 31, 2006 and 2005 the remaining maturities for certificate accounts were:

<i>(In thousands)</i>	2006	2005
Certificate accounts maturing in:		
Under 12 months	\$ 145,056	\$ 63,194
12 to 24 months	13,021	37,067
24 to 36 months	3,474	13,564
Over 36 months	3,525	8,606
Total certificate accounts	\$ 165,076	\$ 122,431

7. Advances from Federal Home Loan Bank of Boston

The Bank has an agreement with Federal Home Loan Bank of Boston (FHLBB) providing for future credit availability of up to twenty times the amount of FHLBB stock held by the Bank, not to exceed 30% of its total assets. The Bank held \$3,898,300 in FHLBB stock at December 31, 2006. In addition to the outstanding advances, the Bank has a \$2,540,000 line of credit available from FHLBB and a \$3,500,000 line of credit available from another correspondent bank, none of which was outstanding at December 31, 2006.



Notes to Consolidated Financial Statements

7. Advances from Federal Home Loan Bank of Boston - (Continued)

FHLBB advances are secured by a blanket lien on the Bank's assets. Outstanding advances with calendar-year maturity dates and weighted average cost of funds at December 31, 2006 and 2005 were as follows:

<i>(Dollars in thousands)</i>			2006		2005	
Year of Maturity	Amount Due	Weighted Average Cost	Amount Due	Weighted Average Cost		
2006	\$ -	0.00 %	\$ 35,503	4.27 %		
2007	30,465	5.03	5,034	3.92		
2008	12,172	4.60	5,921	4.06		
2009	21,718	4.79	6,468	4.19		
2010	2,203	4.32	2,203	4.32		
2011	657	4.09	657	4.09		
2012	684	4.09	684	4.09		
2013	579	4.13	579	4.13		
2014	10	3.94	10	3.94		
Total advances	\$ 68,488	4.83	\$ 57,059	4.20		

During 2004, the Bank prepaid \$9,561,780 of FHLBB advances with a weighted-average rate of 5.29%. The Bank incurred a prepayment penalty of \$498,000 as a part of the transaction.

8. Pension and Other Post-Retirement Benefits

Pension Plan

Prior to September 1, 2005, the Bank participated in a multi-employer defined benefit pension plan covering all of its full time (as defined) employees who had been employed by the Bank for more than six months and were at least twenty-one years of age. Benefits under this plan became fully vested after five years of service. The Bank's net pension cost for the period is the amount of contributions due. Total pension expense was \$280,000 for the year ended December 31, 2006 compared with \$439,000 and \$441,000 for 2005 and 2004, respectively. Current valuations of the Bank's allocation of the plan's pooled assets are not available. Effective September 1, 2005, the Plan was amended and as a result, is considered frozen, with no new participants being accepted. No future compensation will be considered for benefit accruals, and there will be no future credited service, service accruals, or additional accrued benefits.

Defined Contribution Plan

The Bank has a defined contribution 401(k) plan for eligible employees. The Bank provides 75% matching of employee contributions, with a maximum contribution on up to 6% of the employee's salary. The Bank's contribution vests over a 6 year graded vesting schedule. The Bank's contribution to the plan was \$136,000, \$89,000 and \$65,000 for the years ended December 31, 2006, 2005 and 2004, respectively.



Notes to Consolidated Financial Statements

Directors Retirement Plan

Through December 27, 2006, the Bank sponsored a retirement and benefits plan for non-employee directors. All benefits earned were fully accrued based on a fixed amount at December 31, 2006, and were paid to the participating individuals in January, 2007.

Effective December 27, 2006, for fees and compensation earned beginning January 1, 2007, the Bank is sponsoring a deferred compensation plan under which non-employee directors may elect to defer up to 100% of their compensation in the form of either cash or stock-appreciation rights ("SARs"). If a deferral is made in SARs, then at the time of distribution an individual will receive in cash the value of an equivalent number of shares of the Company's stock that could have been purchased at the time of the deferral. The individual will also receive in cash an amount equal to any dividends which would be paid on the equivalent shares during the deferral period. Under terms of the plan, an election to defer compensation, including which form, must be made prior to December 31st of the preceding year. Each year the form (cash or SARs) of previous deferrals may be converted to the other form at the option of the individual participant.

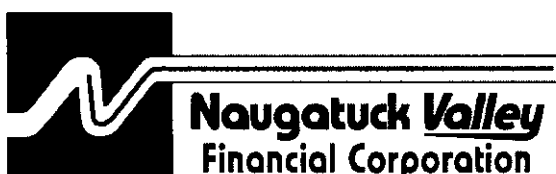
Healthcare Benefits

In addition to providing pension benefits, the Bank provides certain health care benefits to retired employees. Substantially all of the Bank's employees may become eligible for those benefits. The Bank's policy is to accrue the expected cost of providing those benefits during the years that the employee renders the necessary service.

Obligation and Funded Status

The following table summarizes the obligation and funded status, as well as the amounts recognized in the consolidated statements of financial condition for the Directors Retirement Plan and the Healthcare Benefits plan as of December 31, 2006 and 2005:

<i>(In thousands)</i>	Directors Retirement Plan		Healthcare Benefit Plan	
	2006	2005	2006	2005
Measurement date	12/31/2006	12/31/2005	12/31/2006	12/31/2005
Projected benefit obligation	\$ (250)	\$ (388)	\$ (371)	\$ (425)
Fair value of plan assets	-	-	-	-
Funded status	\$ (250)	\$ (388)	\$ (371)	\$ (425)
Accrued benefit cost recognized in the statement of financial condition	\$ (250)	\$ (204)	\$ (371)	\$ (425)



Notes to Consolidated Financial Statements

8. Pension and Other Post-Retirement Benefits – (Continued)

Net Periodic Benefit Cost and Contributions

The benefit costs and contributions the Directors Retirement Plan and the Healthcare Benefits plan for the years ended December 31, 2006 and 2005 were:

<i>(In thousands)</i>	<u>Directors Retirement Plan</u>		<u>Healthcare Benefit Plan</u>	
	2006	2005	2006	2005
Net periodic benefit cost	\$ 86	\$ 55	\$ (54)	\$ 6
Employer contributions	-	-	-	-
Plan participants' contributions	-	-	-	-
Benefits paid during the year	39	79	19	19

Due to the unfunded status of the plans, the Bank expects to contribute the amount of the estimated benefit payments for the next fiscal year, which is \$19,765 for the Healthcare Benefits Plan. Because the Directors Retirement Plan terminated at December 31, 2006, the Bank expects to make no future contributions to that plan.

Assumptions and Effects

The actuarial assumptions used to determine the projected benefit obligations and net periodic benefit cost for the years ended December 31, 2006 and 2005 were as follows:

<i>Weighted-average assumptions:</i>	<u>Directors Retirement Plan</u>		<u>Healthcare Benefit Plan</u>	
	2006	2005	2006	2005
Discount rate	NA	5.75%	6.625%	5.75%
Rate of compensation increase	NA	2.00%	-	-
Medical trend rate next year	-	-	5.00%	5.00%
Ultimate medical trend rate	-	-	5.00%	5.00%
Year ultimate trend rate is achieved	-	-	2006	2006

Assumed health care cost trend rates have a significant effect on the amounts reported for the Healthcare Benefits plan. At December 31, 2006, a one percentage-point increase in the assumed health care trend rates would increase the projected benefit obligation by \$65,220 compared with a decrease of \$53,265 if the assumed health care trend rate were to decrease by one percentage-point.



Notes to Consolidated Financial Statements

9. Employee Stock Ownership Plan

On September 30, 2004, the date the reorganization was consummated, the Bank implemented the Naugatuck Valley Savings and Loan Employee Stock Ownership Plan (the "ESOP"). On September 30, 2004, the ESOP purchased 298,091 shares of the common stock of the Company. To fund the purchase, the ESOP borrowed \$2,980,910 from the Company. The borrowing is at an interest rate of 4.75% and is to be repaid on a pro-rata basis in fifteen annual installments of \$282,520 commencing with the quarter ended December 31, 2004 through September 30, 2019. In addition, dividends paid on the unreleased shares are used to reduce the principal balance of the loan. The collateral for the loan is the common stock of the Company purchased by the ESOP. Contributions by the Bank to the ESOP are discretionary, however, the Bank intends to make annual contributions in an aggregate amount at least equal to the principal and interest requirement on the debt.

The shares of stock purchased by the ESOP are held in a suspense account until they are released for allocation among participants. The shares will be released annually from the suspense account and the released shares will be allocated among the participants on the basis of each participant's compensation for the year of allocation. As shares are released from collateral, the Bank recognizes compensation expense equal to the average market price of the shares during the period and the shares will be outstanding for earning per share purposes. The shares not released are reported as unearned ESOP shares in the capital accounts of the consolidated statements of financial condition. ESOP expense for the years ended December 31, 2006 and 2005 was \$221,166 and \$218,381 respectively. At December 31, 2006 and 2005, there were 19,889 and 19,889 unallocated ESOP shares and 253,402 and 273,291 unreleased ESOP shares respectively. At December 31, 2006 the unreleased shares had an aggregate fair value of \$3,117,000.

10. Equity Incentive Plan

At the annual meeting of stockholders on May 5, 2005, stockholders of the Company approved the Naugatuck Valley Financial Corporation 2005 Equity Incentive Plan (the "Incentive Plan"). Under the Incentive Plan, the Company may grant up to 372,614 stock options and 149,045 shares of restricted stock to its employees, officers and directors for an aggregate amount of up to 521,659 shares of the Company's common stock for issuance upon the grant or exercise of awards. Both incentive stock options and non-statutory stock options may be granted under the Incentive Plan.

On July 26, 2005, the Company awarded 354,580 options to purchase the Company's common stock and 139,712 shares of restricted stock. Stock option awards were granted with an exercise price equal to the market price of the Company's stock at the date of grant (\$11.10) with maximum term of ten years. On March 21, 2006, the Company awarded an additional 6,500 options to purchase the Company's common stock and 1,500 shares of restricted stock. The additional stock awards were granted with an exercise price equal to those granted on July 26, 2005 (\$11.10) with a maximum term of ten years. Both stock option and restricted stock awards vest at 20% per year beginning on the first anniversary of the date of grant.



Notes to Consolidated Financial Statements

10. Equity Incentive Plan – (Continued)

Stock options and restricted stock awards are considered common stock equivalents for the purpose of computing earnings per share on a diluted basis.

A summary of the status of outstanding stock options at December 31, 2006 and 2005 and changes during the year, is as follows:

	2006		2005	
	Number	Weighted	Number	Weighted
	of	Average	of	Average
	Shares	Exercise	Shares	Exercise
		Price		Price
Options outstanding at beginning of year	352,430	\$ -	-	\$ -
Granted	6,500	11.10	354,580	11.10
Forfeited	(5,100)	11.10	(2,150)	11.10
Exercised	-	-	-	-
Expired	(100)	-	-	-
Options outstanding at end of year	353,730	11.10	352,430	11.10
Options exercisable at end of year	69,526	11.10	-	-
Weighted-average fair value of options granted during the year		\$ 2.25		\$ 2.47

The Company adopted Financial Accounting Standards Board's SFAS No.123(R), "Share Based Payment", during 2005, prior to the mandatory compliance date for the Company of January 1, 2006. In accordance with Statement No.123 (R), the Company has recorded share-based compensation expense related to outstanding stock option and restricted stock awards based upon the fair value at the date of grant over the vesting period of such awards on a straight-line basis.

The fair value of each restricted stock allocation, based on the market price at the date of grant, is recorded to unearned stock awards. Compensation expenses related to unearned restricted shares are amortized to compensation, taxes and benefits expense over the vesting period of the restricted stock awards.

The fair value of each stock option award is estimated on the date of grant using the Black-Scholes option pricing method which includes several assumptions such as volatility, expected dividends, expected term and risk-free rate for each stock option award.



Notes to Consolidated Financial Statements

In determining the expected term of the option awards, the Company elected to follow the simplified method as permitted by the SEC Staff Accounting Bulletin 107, which was issued to provide guidance on the implementation of SFAS 123(R). Under this method, the Company has estimated the expected term of the options as being equal to the average of the vesting term plus the original contractual term. The Company estimated its volatility using the historical volatility of other, similar companies during a period of time equal to the expected life of the options. The risk-free rate for the periods within the contractual life of the options is based upon the U.S. Treasury yield curve in effect at the time of grant. Assumptions used to determine the weighted-average fair value of stock options granted were as follows:

Grant date	March 21, 2006	July 26, 2005
Dividend yield	1.89%	1.44%
Expected volatility	11.20%	11.47%
Risk-free rate	4.61%	4.18%
Expected life in years	6.5	6.5
Weighted average fair value of options at grant date	\$ 2.25	\$ 2.47

The Company recorded share-based compensation expense of \$435,860 and \$178,352 for the year ended December 31, 2006 and 2005, respectively, in connection with the stock option and restricted stock awards. At December 31, 2006, the Company has approximately \$685,000 of unrecorded option expense to be recognized over the remaining vesting period of the options.

11. Income Taxes

The Bank's wholly-owned subsidiary, the Naugatuck Valley Mortgage Servicing Corporation, qualifies and operates as a Connecticut passive investment company pursuant to legislation. Because the subsidiary earns income from passive investments which is exempt from Connecticut Corporation Business Tax and its dividends to the Bank are exempt from state tax, the Bank no longer expects to incur state income tax expense.

Deferred income taxes reflect the impact of "temporary differences" between the amount of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws and regulations. Principal items making up the deferred income tax provision include a carry forward of charitable contributions, the provision for loan losses, accelerated tax depreciation and deferred mortgage fee income. The Company records a valuation allowance against deferred tax assets if, based on the weight of available evidence, it is more likely than not, that some or all of the deferred tax assets will not be realized. The Company believes that all deferred tax assets will be realized in the future and that no valuation allowance is necessary.



Notes to Consolidated Financial Statements

11. Income Taxes – (Continued)

Income taxes receivable and payable included in the balance sheet at December 31, 2006 and 2005 were:

<i>(In thousands)</i>	2006	2005
Current tax receivable	\$ 84	\$ 57
Deferred tax receivable		
Charitable contributions carryforward	\$ 365	\$ 428
Reserve for loan losses	704	552
Post-retirement benefits	212	214
Deferred income	213	138
Available-for-sale securities	168	232
Total deferred tax receivable	1,662	1,564
Deferred tax payable		
Depreciation	\$ (174)	\$ (104)
Other items	(38)	(21)
Total deferred tax payable	(212)	(125)
Net deferred tax receivable	\$ 1,450	\$ 1,439

The provision for income tax expense for the year ended December 31, 2006, 2005 and 2004 consisted of:

<i>(In thousands)</i>	2006	2005	2004
Current income tax expense	\$ 279	\$ 627	\$ 478
Deferred income tax expense (benefit), due to:			
Charitable contributions	63	37	(465)
Reserve for loan losses	(152)	(170)	(42)
Deferred income	(76)	4	(25)
Post retirement benefits	2	6	26
Depreciation	71	(49)	43
Other items	17	(5)	(1)
Total deferred income tax expense (benefit)	(75)	(177)	(464)
Provision for income taxes	\$ 204	\$ 450	\$ 14



Notes to Consolidated Financial Statements

A reconciliation of the statutory federal income tax rate applied to income before income taxes with the income tax provision is as follows:

<i>(Dollars in thousands)</i>	Year Ended December 31,		
	2006	2005	2004
Income tax expense at statutory rate of 34%	\$ 562	\$ 801	\$ 146
Increase (decrease) in income tax expense resulting from:			
Nondeductible compensation expense	104	-	-
Income exempt from income tax	(321)	(193)	(68)
Changes in tax bad debt base year reserves	(145)	(160)	(65)
Other items, net	4	2	1
Provision for income taxes	\$ 204	\$ 450	\$ 14
Effective rate of income tax expense	12.3%	19.1%	3.3%

Retained earnings at December 31, 2006 includes a contingency reserve for loan losses of \$1,867,000, which represents the tax reserve balance existing at December 31, 1987, and is maintained in accordance with provisions of the Internal Revenue Code applicable to thrift institutions. It is not anticipated that the Company will incur a federal income tax liability related to the reduction of this reserve and accordingly, deferred income taxes of \$635,000 has not been recognized as of December 31, 2006.

12. Consolidated Statement of Comprehensive Income

The source of the Company's other comprehensive income is the unrealized gains and losses on its available for sale securities.

<i>(In thousands)</i>	For the Years Ended December 31,		
	2006	2005	2004
Net income	\$ 1,448	\$ 1,905	\$ 415
Other comprehensive loss:			
Unrealized gain (loss) on securities available-for-sale	195	(600)	(601)
Reclassification adjustment for (gains) losses realized in net income	(6)	(47)	156
Other comprehensive income (loss) before tax effect	189	(647)	(445)
Income tax expense (benefit) related to items of other comprehensive income (loss)	64	(220)	(151)
Other comprehensive income (loss) net of tax effect	125	(427)	(294)
Total comprehensive income	\$ 1,573	\$ 1,478	\$ 121



Notes to Consolidated Financial Statements

13. Regulatory Capital

The Company, as a federally chartered holding company, is not subject to regulatory capital requirements. The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements.

The Office of Thrift Supervision (OTS) regulations require savings institutions to maintain minimum levels of regulatory capital. Under the regulations in effect at December 31, 2006, the Bank was required to maintain a minimum ratio of tangible capital to total adjusted assets of 1.5%; a minimum ratio of Tier 1 (core) capital to total adjusted assets of 4.0%; a minimum ratio of Tier I capital to risk-weighted assets of 4.0% and a minimum ratio of total (core and supplementary) capital to risk-weighted assets of 8.0%. As of December 31, 2005 the Bank meets all capital requirements to which it is subject.

At December 31, 2006 the Bank was considered "well capitalized" for regulatory purposes. To be categorized as well capitalized, the Bank must maintain a minimum ratio of tangible equity capital to total tangible assets of 2.00%; a minimum ratio of Tier 1 (core) capital to adjusted total assets of 5.00%; a minimum ratio of Tier I capital to risk-weighted assets of 6.00% and a minimum ratio of total (core and supplementary) capital to risk-weighted assets of 10.00%. There have been no subsequent conditions or events which management believes have changed the Bank's status.

The following is a summary of the Bank's actual capital as computed under the standards established by the OTS at December 31, 2006 and 2005, respectively.

<i>(Dollars in thousands)</i>	2006		2005	
	Amount	Ratio	Amount	Ratio
Tier I (Core) Capital (to Adjusted Total Assets)	\$ 38,904	9.53%	\$ 39,885	11.42%
Tier I Risk-Based Capital (to Risk-Weighted Assets)	38,904	13.56%	39,885	17.07%
Total Risk-Based Capital (to Risk-Weighted Assets)	40,975	14.29%	41,763	17.88%
Tangible Equity Ratio (to Tangible Assets)	38,904	9.53%	39,885	11.42%

The ability of the Company to pay dividends depends, in part, on the ability of the Bank to pay dividends to the Company. The Bank will not be able to declare or pay a cash dividend on, or repurchase any of its common stock, if the effect thereof would be to reduce the regulatory capital of the Bank to an amount below amounts required under OTS rules and regulations. During 2006, the Bank received regulatory approval and paid a dividend of \$2,500,000 to the Company.



Notes to Consolidated Financial Statements

The measurement of the Bank's capital as computed under regulatory standards differs from its measurement under generally accepted accounting principles. A reconciliation of the Bank's capital follows:

<i>(In thousands)</i>	December 31,	
	2006	2005
Total capital as calculated under generally accepted accounting principles (GAAP Capital)	\$ 38,850	\$ 39,795
Adjustments to reconcile Total GAAP Capital to Regulatory Capital:		
Intangible assets	(188)	(222)
Accumulated other comprehensive income from available-for-sale securities	242	312
Tier I Risk-Based Capital	38,904	39,885
Includible portion of allowance for loan losses	2,071	1,878
Total Risk-Based Capital	\$ 40,975	\$ 41,763

14. Earnings per Share

Basic net income per common share is calculated by dividing the net income available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted net income per common share is computed in a manner similar to basic net income per common share except that the weighted-average number of common shares outstanding is increased to include the incremental common shares (as computed using the treasury stock method) that would have been outstanding if all potentially dilutive common stock equivalents were issued during the period. The Company's common stock equivalents relate solely to stock option and restricted stock awards. Anti-dilutive shares are common stock equivalents with weighted-average exercise prices in excess of the weighted-average market value for the periods presented. The Company had no anti-dilutive common shares outstanding for the year ended December 31, 2006. Unallocated common shares held by the ESOP are not included in the weighted-average number of common shares outstanding for purposes of calculating either basic or diluted net income per common share.

	For the years ended December 31,	
	2006	2005
Net income and income available to common stockholders	\$ 1,448,000	\$ 1,905,000
Weighted-average shares outstanding during the period		
Basic	7,275,718	7,311,249
Effect of dilutive stock options and restrictive stock awards	5,864	5,707
Diluted	7,281,582	7,316,956
Net income per common share:		
Basic and Diluted Earnings per share	\$ 0.20	\$ 0.26



Notes to Consolidated Financial Statements

15. Financial Instruments

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet. The following table summarizes these financial instruments and other commitments and contingent liabilities as of December 31, 2006 and 2005:

<i>(In thousands)</i>	2006	2005
Commitments to extend credit:		
Loan commitments	\$ 9,933	\$ 7,578
Unused lines of credit	21,057	18,363
Amounts due mortgagors on construction loans	21,713	15,025
Amounts due on commercial loans	6,374	3,434
Commercial letters of credit	6,758	1,969

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments are principally collateralized by mortgages on real estate, generally have fixed expiration dates or other termination clauses and may require payment of fees. Since some of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The estimated fair value of the Company's financial instruments follows:

<i>(In thousands)</i>	December 31,			
	2006		2005	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Cash and cash equivalents	\$ 7,942	\$ 7,942	\$ 8,951	\$ 8,951
Investment securities	70,267	70,258	63,049	63,036
Loans receivable, net	308,376	303,073	259,427	256,278
Accrued income receivable	1,904	1,904	1,525	1,525
Financial Liabilities				
Deposits	\$ 289,198	\$ 269,701	\$ 240,846	\$ 239,514
Federal Home Loan Bank advances	68,488	67,847	57,059	56,449
Mortgagors' escrow accounts	3,495	3,495	3,202	3,202



Notes to Consolidated Financial Statements

16. Selected Quarterly Consolidated Financial Information (unaudited)

The following tables present quarterly consolidated information for the Company for 2006, 2005 and 2004.

<i>(In thousands)</i>	For the Year Ended December 31, 2006			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest and dividend income	\$ 5,644	\$ 5,329	\$ 4,990	\$ 4,787
Interest expense	2,847	2,490	2,097	1,916
Net interest income	2,797	2,839	2,893	2,871
Provision for loan losses	62	-	68	62
Net interest income after provision for loan losses	2,735	2,839	2,825	2,809
Noninterest income	499	522	477	450
Noninterest expense	3,029	3,001	2,819	2,655
Income before provision for income tax (benefit)	205	360	483	604
Provision for income tax (benefit)	54	(54)	70	134
Net income	\$ 151	\$ 414	\$ 413	\$ 470

<i>(In thousands)</i>	For the Year Ended December 31, 2005			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest and dividend income	\$ 4,545	\$ 4,124	\$ 3,807	\$ 3,432
Interest expense	1,668	1,367	1,093	813
Net interest income	2,877	2,757	2,714	2,619
Provision for loan losses	-	-	17	15
Net interest income after provision for loan losses	2,877	2,757	2,697	2,604
Noninterest income	425	372	384	336
Noninterest expense	2,604	2,594	2,523	2,376
Income before provision for income tax (benefit)	698	535	558	564
Provision for income tax (benefit)	151	(2)	140	161
Net income	\$ 547	\$ 537	\$ 418	\$ 403



Notes to Consolidated Financial Statements

16. Selected Quarterly Consolidated Financial Information (unaudited) - (Continued)

<i>(In thousands)</i>	For the Year Ended December 31, 2004			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest and dividend income	\$ 3,365	\$ 3,265	\$ 3,057	\$ 3,026
Interest expense	765	942	916	936
Net interest income	2,600	2,323	2,141	2,090
Provision for loan losses	-	-	-	-
Net interest income after provision for loan losses	2,600	2,323	2,141	2,090
Noninterest income	290	149	306	333
Noninterest expense	2,168	3,891	1,865	1,879
Income (loss) before provision (benefit) for income taxes	722	(1,419)	582	544
Provision (benefit) for income taxes	192	(526)	182	166
Net income (loss)	\$ 530	\$ (893)	\$ 400	\$ 378



Notes to Consolidated Financial Statements

17. Parent Company Only Financial Statements

The following financial statements are for the Company (Naugatuck Valley Financial Corporation) only, and should be read in conjunction with the consolidated financial statements of the Company.

Statements of Financial Condition

<i>(In thousands)</i>	December 31,	
	2006	2005
ASSETS		
Cash on deposit with Naugatuck Valley Savings and Loan	\$ 3,124	\$ 1,581
Investment in subsidiary, Naugatuck Valley Savings and Loan	38,850	39,794
Investment securities	5,416	9,194
Loan to ESOP	2,655	2,804
Deferred income taxes	408	551
Other assets	642	51
Total assets	\$ 51,095	\$ 53,975
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities	\$ 11	\$ 3,011
Stockholders' equity	51,084	50,964
Total liabilities and stockholders' equity	\$ 51,095	\$ 53,975

Statements of Income

For the Year Ended December 31, 2006 and 2005 and the Period From Inception (September 30, 2004) through December 31, 2004

<i>(In thousands)</i>	2006	2005	2004
Interest income	\$ 442	\$ 506	\$ 90
Other expense			
Charitable contribution	-	-	1,521
Other expenses	309	444	26
Total other expense	309	444	1,547
Income (loss) before income tax (benefit) and equity in undistributed net income of subsidiary	133	62	(1,457)
Income tax (benefit)	47	21	(495)
Income (loss) before equity in undistributed net income of subsidiary	86	41	(962)
Equity in undistributed net income of subsidiary	1,362	1,864	488
Net income (loss)	\$ 1,448	\$ 1,905	\$ (474)



Notes to Consolidated Financial Statements

17. Parent Company Only Financial Statements – (Continued)

Statements of Cash flows

For the Year Ended December 31, 2006, 2005 and the Period From Inception (September 30, 2004) through December 31, 2004

<i>(In thousands)</i>	For the Years Ended December 31,		
	2006	2005	2004
Net cash provided (used) by operating activities	\$ 278	\$ 243	\$ (39)
Cash flows from investing activities			
Purchase of available-for-sale securities	-	-	(11,014)
Paydowns and maturities of available-for-sale securities	3,854	1,591	-
Loan to ESOP	-	-	(2,981)
Principal payments received from ESOP	-	143	-
Investment in subsidiary, Naugatuck Valley Savings and Loan	2,500	-	(15,870)
Net cash provided (used) by investing activities	6,354	1,734	(29,865)
Cash flows from financing activities			
Payment of borrowings from subsidiary	(2,981)	-	-
Common stock repurchased	(1,491)	(1,851)	-
Cash dividends to common shareholders	(617)	(500)	-
Release of ESOP shares	-	217	-
Proceeds from issuance of common stock	-	-	32,601
Cost of issuance of common stock	-	-	(959)
Net cash (used) provided by financing activities	(5,089)	(2,134)	31,642
Increase (decrease) in cash and cash equivalents	1,543	(157)	1,738
Cash and cash equivalents at beginning of year	1,581	1,738	-
Cash and cash equivalents at end of year	\$ 3,124	\$ 1,581	\$ 1,738

Supplemental Disclosures:

Non-cash investing activities:

Loan to acquire ESOP shares	\$ -	\$ -	\$ 2,981
Capital contributed on acquisition of subsidiary	-	-	22,010

Cash paid during the year for:

Interest	\$ -	\$ -	\$ -
Income taxes	-	-	-

Directors and Executive Officers

Directors of Naugatuck Valley Financial Corporation, Naugatuck Valley Mutual Holding Company and Naugatuck Valley Savings and Loan

Carlos S. Batista

*Vice President – Bristol, Inc. a division of Emerson
Process Management*

Richard M. Famiglietti

Owner – CM Property Management

Ronald D. Lengyel

*Chairman of the Board – Naugatuck Valley
Financial Corporation, Naugatuck Valley Mutual
Holding Company and Naugatuck Valley
Savings and Loan*

Director – Connecticut Water Service, Inc.

James A. Mengacci

Owner – James A. Mengacci Associates LLC

Michael S. Plude, CPA

Managing Partner – Kaskie, Plude & Pacowta, LLC

John C. Roman

*President and Chief Executive Officer – Naugatuck
Valley Financial Corporation, Naugatuck Valley
Mutual Holding Company and Naugatuck Valley
Savings and Loan*

Camilo P. Vieira

Consultant – CM Property Management

Jane H. Walsh

*Senior Vice President – Naugatuck Valley
Financial Corporation, Naugatuck Valley Mutual
Holding Company and Naugatuck Valley Savings
and Loan*

Executive Officers of Naugatuck Valley Financial Corporation, Naugatuck Valley Mutual Holding Company and Naugatuck Valley Savings and Loan

John C. Roman

President and Chief Executive Officer

Dominic J. Alegi, Jr.

Executive Vice President

Jane H. Walsh

Senior Vice President

William C. Nimons

Senior Vice President

Mark S. Graveline

Senior Vice President

Lee R. Schlesinger

Vice President and Treasurer

Investor and Corporate Information

Annual Meeting

The annual meeting of stockholders will be held at 10:30 a.m., local time, on May 3, 2007 in the Community Room at Naugatuck Valley Savings and Loan's main office at 333 Church Street, Naugatuck, Connecticut 06770.

Stock Listing

Naugatuck Valley Financial Corporation common stock is listed on the Nasdaq Global Market under the symbol "NVSL."

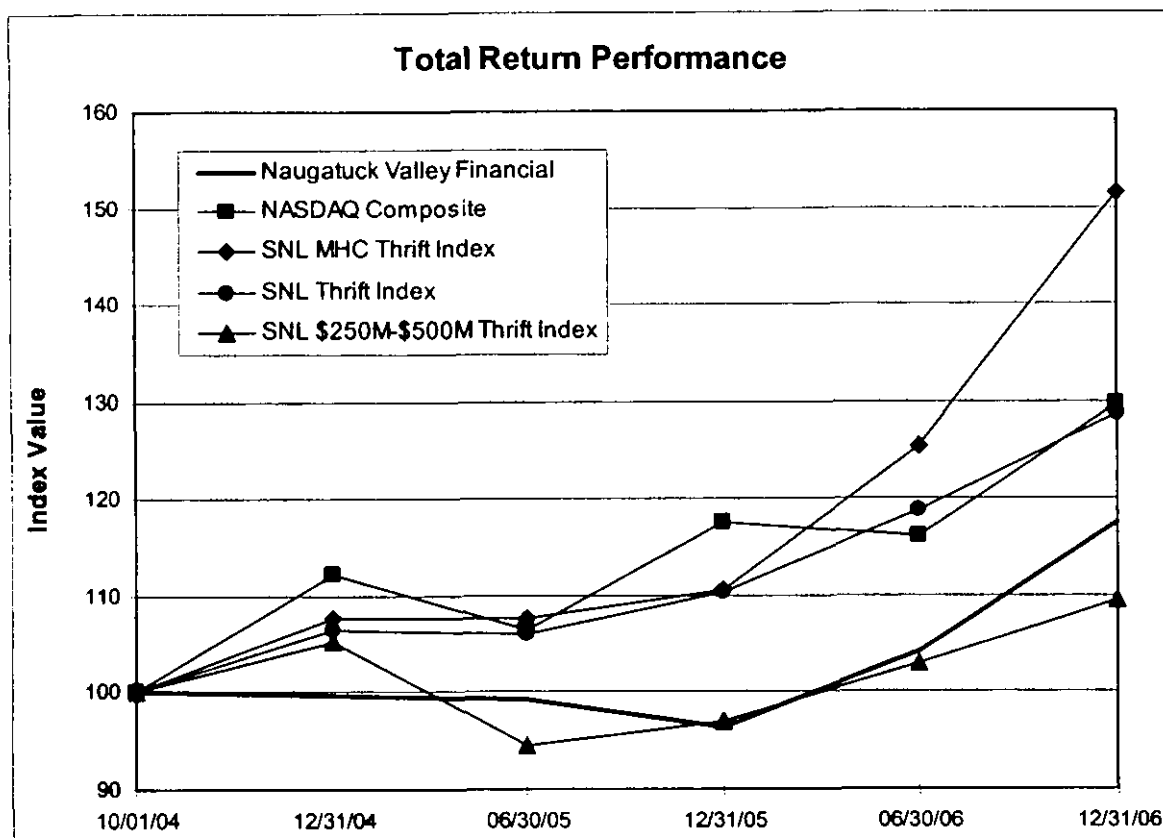
Price Range of Common Stock

On October 1, 2004, Naugatuck Valley Financial common stock commenced trading on the Nasdaq National Market. At March 5, 2007, there were 842 holders of record of Naugatuck Valley Financial common stock. The following table sets forth the high and low sales prices of the common stock, as reported on the Nasdaq National Market, and the dividend paid by Naugatuck Valley Financial during each quarter since trading commenced.

	<u>Dividends</u>	<u>High</u>	<u>Low</u>
<u>2005:</u>			
First Quarter	\$0.04	\$11.85	\$10.32
Second Quarter	0.04	10.84	9.80
Third Quarter	0.04	13.09	10.45
Fourth Quarter	\$0.04	\$13.00	\$10.20
<u>2006:</u>			
First Quarter	\$0.05	\$10.95	\$10.25
Second Quarter	0.05	11.80	10.17
Third Quarter	0.05	11.67	10.71
Fourth Quarter	\$0.05	\$12.65	\$10.79

Stock Performance Graph

The following graph compares the cumulative total stockholder return on Naugatuck Valley Financial's common stock with the cumulative total return on the NASDAQ Composite (U.S. Companies), SNL MHC Thrift Index and the SNL \$250M-\$500M Thrift Index. Total return assumes the reinvestment of all dividends. The graph assumes \$100 was invested at the close of business on October 1, 2004, the initial day of trading of Naugatuck Valley Financial's common stock.



Index	Period Ending					
	10/01/04	12/31/04	06/30/05	12/31/05	06/30/06	12/31/06
Naugatuck Valley Financial	100.00	99.63	99.36	96.31	104.30	117.68
NASDAQ Composite	100.00	112.19	106.44	117.50	116.23	129.71
SNL MHC Thrift Index	100.00	107.69	107.72	110.64	125.37	151.52
SNL Thrift Index	100.00	106.57	106.14	110.33	118.91	128.61
SNL \$250M-\$500M Thrift Index	100.00	105.16	94.62	96.98	103.07	109.60

Stockholder and General Inquiries

John C. Roman
President and Chief Executive Officer
Naugatuck Valley Financial Corporation
333 Church Street
Naugatuck, Connecticut 06770
(203) 720-5000

Annual and Other Reports

A copy of the Naugatuck Valley Financial Annual Report on Form 10-K, without exhibits, for the year ended December 31, 2006, as filed with the Securities and Exchange Commission, may be obtained without charge by contacting Bernadette A. Mole, Corporate Secretary, Naugatuck Valley Financial Corporation, 333 Church Street, Naugatuck, Connecticut 06770.

Independent Registered Public Accounting Firm

Whittlesey & Hadley, P.C.
147 Charter Oak Avenue
Hartford, Connecticut 06106

Transfer Agent

Registrar and Transfer Company
10 Commerce Drive
Cranford, New Jersey 07016

Corporate Counsel

Muldoon Murphy & Aguggia LLP
5101 Wisconsin Avenue, NW
Washington, DC 20016

Office Locations

Main Office

333 Church Street
Naugatuck, Connecticut 06770

Branch Offices

1009 New Haven Road
Naugatuck, Connecticut 06770

249 West Street
Seymour, Connecticut 06483

127 South Main Street
Beacon Falls, Connecticut 06403

504 Bridgeport Avenue
Shelton, Connecticut 06484

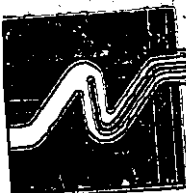
1699 Highland Avenue
Cheshire, Connecticut 06410

1570 Southford Road
Southbury, Connecticut 06488

49 Pershing Drive
Derby, Connecticut 06418

1030 Hamilton Avenue
Waterbury, Connecticut 06706

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Naugatuck Valley
Financial Corporation

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